REQUEST FOR ADOPTION OF PROPOSED AMENDMENTS TO REGULATION SECTION 25136, CALIFORNIA CODE OF REGULATIONS, TITLE 18, RELATING TO THE MARKET-BASED RULES OF SALES OTHER THAN SALES OF TANGIBLE PERSONAL PROPERTY

On February 20, 2010, staff held the first interested parties meeting and requested public input about new regulation language to implement the market-based rules of sales of other than sales of tangible personal property in Revenue and Taxation Code section 25136, subdivision (b), operative for taxable years beginning on or after January 1, 2011. The main issues to be addressed were sales of services and sales of intangible property. At that interested parties meeting, staff did not provide language, but did present a 50-state analysis of other states' provisions for sales of services and intangible property. There was considerable public input from which staff began drafting the proposed amendments to the regulation.

On July 19, 2010, staff held the second interested parties meeting for the public's input on the first draft of proposed language for the market-based rules of sales of services and intangible property.

On November 8, 2010, a third interested parties meeting was held for public comment on the second draft of proposed language for this regulation.

The main comments at these meetings related to concerns as to what kind of documentation different types of taxpayers would have available to them depending on the size of the taxpayer, its sophistication and the particular industry standards of the taxpayer. Additionally, comments were provided on how to assign a sale in the event there was no available documentation to the taxpayer and the order of best evidence. Comments also indicated that neither the Franchise Tax Board nor the taxpayers should be able to pick which “cascading rule” fit it best. Definitions, examples and special rules were discussed.

After the third interested parties meeting, staff further revised the proposed language to provide that the cascading rules appear in order of what is the best available evidence to determine where the benefit of the services is received or the location of the use of the intangible property, with the requirement that the taxpayer or the Franchise Tax Board must use the first rule which is presented as a presumption before it may avail itself of the next cascading rule, and may then only use the 3rd or 4th rule if none of the rules above provide a methodology for the location of the market. There are numerous definitions, examples, and several special rules.

On December 2, 2010, staff asked the Franchise Tax Board to allow staff to move into the formal regulatory process. The Board approved staff’s request, and a formal Notice of Hearing was published on June 17, 2011 (Exhibit A), along with the Initial Statement of Reasons (Exhibit B) and proposed text.

On August 10, 2011, staff held the required public hearing at the Franchise Tax Board’s central office to receive public comments on the proposed amendments to Regulation section 25136. The hearing was well attended. Oral and written comments were submitted.

In response to some of those comments, staff published a 15-day Notice setting forth certain "sufficiently related changes" within the meaning of Government Code section 11346.8, subdivision (c). The Notice and accompanying change language were mailed and posted on October 7, 2011, with comments due no later than October 24, 2011 (Exhibit C). Written comments were received and after review of those comments, staff mailed and posted, on October 27, 2011, a second 15-day notice with comments due no later than November 14, 2011 (Exhibit D). On November 14, 2011, written comments were received; after review of those comments staff determined that no further change to the regulation language was necessary.

All comments received in the 45-day comment period and at the hearing have been addressed in detail in the Staff Summary of Comments, Responses and Recommendations in Conjunction with Hearing on California Code of Regulations, title 18, Section 25136 (Staff Summary), on August 10, 2011 (Exhibit E). All comments received during the 1st 15-day comment period have been addressed in detail in the Staff Summary for that 1st 15-day notice, mailed and posted on October 7, 2011 (Exhibit F). All comments received during the 2nd 15-day comment period have been addressed in detail in the Staff Summary for that 2nd 15-day notice, mailed and posted on October 27, 2011 (Exhibit G). All comments that were received during the entire regulatory process are attached as Exhibit H.

The final language appears in Exhibit I of this package.

This regulation as amended shall be operative for taxable years beginning on or after January 1, 2011.

Staff requests that the Board adopt the proposed amendments to Regulation section 25136, now renumbered 25136-2.

TITLE 18. FRANCHISE TAX BOARD

As required by section 11346.4 of the Government Code, this is notice that a public hearing has been scheduled to be held at 1:00 p.m., August 10, 2011, at 9645 Butterfield Way, Town Center, Golden State Room A/B, Sacramento, California, to amend section 25136 under Title 18 of the California Code of Regulations, pertaining to sales of other than tangible personal property.

An employee of the Franchise Tax Board will conduct the hearing. Interested persons are invited to present comments, written or oral, concerning the proposed regulatory action. It is requested, but not required, that persons who make oral comments at the hearing also submit a written copy of their comments at the hearing.

Government Code section 15702, subdivision (b), provides for consideration by the three-member Franchise Tax Board of any proposed regulatory action if any person makes such a request in writing.

WRITTEN COMMENT PERIOD

Written comments will be accepted until 5:00 p.m., August 10, 2011. All relevant matters presented will be considered before the proposed regulatory action is taken. Comments should be submitted to the agency officer below.

AUTHORITY AND REFERENCE

Section 19503 of the Revenue and Taxation Code (RTC) authorizes the Franchise Tax Board to prescribe regulations necessary for the enforcement of Part 10 (commencing with section 17001), Part 10.2 (commencing with section 18401), Part 10.7 (commencing with section 21001) and Part 11 (commencing with section 23001) of the Revenue and Taxation Code. RTC section 25136, subdivision (c), specifically provides that "[t]he Franchise Tax Board may prescribe those regulations as necessary or appropriate to carry out the purposes of subdivision (b)." The proposed regulatory action interprets, implements, and makes specific section 25136, subdivision (b), of the Revenue and Taxation Code.

INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW

Taxpayers who have business activities within and without California are required to determine the amount of income properly attributed to activities in California by use of the Uniform Division of Income for Tax Purposes Act (UDITPA), and RTC Section 25120 et seq. Under UDITPA, business income is assigned to a state either through the application of a three-factor apportionment formula that separately compares a business' property, payroll and sales within California to those values everywhere or a single sales factor formula, if elected by the taxpayer, which compares a business' sales within California to sales everywhere. Under the three-factor apportionment formula, as applied by California, the percentages are added together, with the sales factor counted twice (see RTC section 25128), and the resulting sum of these four factors is then divided by four. Under the single sales factor formula which becomes operative for taxpayers who elect it for tax years

beginning on or after January 1, 2011, the taxpayer's sales factor percentage (sales within California divided by sales everywhere) is applied to the business income of the taxpayer to determine the percentage of business income attributable to California.

The sales factor component of the UDITPA apportionment formula has three assignment rules. Sales of tangible personal property are generally assigned to the location of the customer (the "destination" rule contained in RTC section 25135). Sales of other than tangible personal property are assigned to a jurisdiction based on either (1) where the income-producing activity/costs of performance related to the sale occurs (RTC section 25136(a), or (2) if the taxpayer makes a single sales factor election, sales of other than tangible personal property are assigned to the numerator of the sales factor based upon the location where the benefit of the services was received or the location of the use of the intangibles (25136(b)).

The proposed regulations address the assignment rules set forth in RTC section 25136, subdivision (b), and are meant to supply additional guidance pertaining to how to determine where the benefit of the service is received, and where intangibles are used, by the purchaser of the taxpayer's services or intangibles. The regulation is divided into various subsections.

Subsection (a) of the regulation states the general rule that sales of other than tangible personal property are in this state if the taxpayer's market is in this state. These market-based rules for assignment of sales of other than tangible personal property are in addition to those described in RTC section 25135, which contains the rules for assignment of sales of tangible personal property.

Subsection (b) defines terms contained within the regulation.

In subsection (b)(1) the term "benefit of a service is received" is defined as the location where the taxpayer's customer has either directly or indirectly received value from the delivery of a service.

The examples in subsection (b)(1) are provided to illustrate where the benefit of a service is received for purposes of the statute in specific situations.

In subsection (b)(2) the term "service" is defined as consisting of activities engaged in by one for another for consideration. The definition excludes activities outside the taxpayer's regular course of business as well as activities undertaken for other members of the taxpayer's unitary business.

Subsection (b)(3) defines the term "cannot be determined" as meaning that the taxpayer's records, or the records of the taxpayer's customer available to the taxpayer, do not indicate the location where the benefit of the service was received or where the intangible property was used. The alternative method is a reasonable approximation of the taxpayer's market and is defined and discussed below.

In subsection (b)(4) the definition of "commercial domicile" is defined as the place where the trade or business is directed or managed by the taxpayer.

Subsection (b)(5) lists, without limitation, twenty-two (22) specific terms and ends with the catch-all, "other similar intangible assets."

In subsections (b)(5)(A), (B) and (C), the terms "marketing intangible," "non-marketing and manufacturing intangible," and "mixed intangible" are defined using existing Massachusetts law on assignment of intangible property. A "marketing intangible" is intangible property whose value lies predominantly in the marketing of the intangible property. A "non-marketing and manufacturing intangible" is intangible property where the value of the intangible property lies predominately in its non-marketing or manufacturing use. "Mixed intangible" is intangible property whose value includes both the license of a marketing intangible property and a license of a non-marketing or manufacturing intangible property.

In subsection (b)(6) the term "intangible personal property is used" is defined as the location where the intangible property is employed by the taxpayer's customer or licensee.

In (b)(7) the term "reasonably approximated" is defined by reference to the business of the taxpayer's customer. Publicly available information, including population, may be used. Information that is specific in nature is preferred over information that is general in nature.

In subsection (b)(8) the term "to the extent" is defined to make clear that a receipt is to be divided proportionally between states when it relates to activities in more than one state.

Subsection (c) addresses assignment of sales from services to the extent that the benefit of the service is received in this state by the taxpayer's customer. This introductory language mirrors the language of the underlying statute, RTC section 25136, subdivision (b), and is segue to the cascading rules below.

Subsection (c)(1) sets forth the billing address as the primary rule for assigning sales of services where the taxpayer's customer is an individual. Subsection (c)(1) also provides a safe harbor rule for taxpayers so that if the taxpayer uses the individual customer's billing address as the mechanism for assignment of the sales, then the Franchise Tax Board must accept this presumptively correct assignment.

Subsection (c)(1)(A) sets forth the secondary rule for assignment which is applicable only when the taxpayer establishes by a preponderance of evidence that either the contract between the taxpayer and its customer or the taxpayer's books and records kept in the regular course of its business indicate the extent to which the benefit of the service was received in this state. If the taxpayer uses this alternative method of assigning the sales, this subsection allows the Franchise Tax Board the right to audit the alternative method to determine whether or not the taxpayer has overcome the presumption that the benefit of the service was received at the customer’s billing address and also that the taxpayer's method reasonably reflects where the benefit of the service was received by the taxpayer's customers.

If the assignment cannot be determined under the alternatives set forth in subsections (c)(1) and (c)(1)(A), then subsection (c)(1)(B) states the determination of the location shall be reasonably approximated.

Subsection (c)(1)(C) provides examples for how the cascading rules in subsection (c)(1) operate. Example 1 illustrates assignment under subsection (c)(1). Example 2 provides an example of when the billing address presumption is overcome and assignment under subsection (c)(1)(A) is proper. Example 3 illustrates when the billing address presumption is not overcome by the taxpayer and therefore assignment under subsection (c)(1) is proper. One more example needs to be added to illustrate assignment by reasonable approximation under subsection (c)(1)(B).

Subsection (c)(2) addresses assignment of sales where the benefit of the services was received by corporate or other business entities.

Subsection (c)(2)(A) sets forth the first rule of assignment, which provides that the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records are presumed to establish the location of where the benefit of the service is received, notwithstanding the billing address of the taxpayer's customer. The presumption may be overcome by a preponderance of the evidence that the contract and the books and records do not indicate the actual location of where the benefit of the service was received.

Subsection (c)(2)(B) sets forth the second rule of assignment that the location where the benefit is received is to be reasonably approximated by reference to the activities of the taxpayer's customer. The second rule only applies if the presumption in favor the first assignment rule is overcome.

Subsection (c)(2)(C) sets forth the third rule of assignment which is the location from which the taxpayer's customer placed the order for the service. This rule only applies if where the benefit was received cannot be determined under the first two rules provided in subsections (c)(2)(A) and (B). This provision is the third-in-line cascading rule that seeks to establish the taxpayer's market in the event of a lack of best evidence, i.e. the contract, the taxpayer's books and records, and the inability to reasonably approximate the location of the taxpayer's market. This alternative is only available in the event the first two cascading rules cannot determine the location where the benefit of the service was received.

Subsection (c)(2)(D) sets forth the final rule of assignment as the taxpayer's customer's billing address. This final rule is a catch-all when none of the provisions above can establish the location where the benefit of the services was received.

Subsection (c)(2)(E) gives examples showing how the cascading rules in subsection (c)(2) operate. Examples I, 2 and 3 illustrate assignment under subsection (c)(2)(A) using a taxpayer's books and records. Example 4.a illustrates assignment under subsection (c)(2)(A) using a taxpayer's books and records and example 4.b illustrates assignment under subsection (c)(2)(B) by reasonably approximating where the benefit of the services was received. Example 5.a illustrates assignment under subsection (c)(2)(C) when the first three cascading rules are unavailable and the sale must be assigned to the location from where

the services were ordered and example 5.b illustrates subsection (c)(2)(D) where the first four cascading rules are unavailable and the sale must be assigned to the customer's billing address.

Subsection (d) addresses assignment of sales from intangible property. Sales are assigned to this state to the extent the intangible property is used in this state.

Subsection (d)(1) addresses assignment of sales from intangible property where a complete transfer of all property rights for a jurisdiction or jurisdictions has been made.

Subsection (d)(1)(A) sets forth the first assignment rule for a sale where a complete transfer of all rights in intangible property has occurred. It provides that if the contract between the taxpayer and the purchaser indicates the extent of the location[s] where the purchaser will use intangible property at the time of purchase, then the assignment will be on that basis. Subsection (d)(1)(A) continues by stating that if the contract or the taxpayer's books and records do not specify where the purchaser will use the property, then the use the taxpayer made of the intangible property prior to the purchase will be used. The presumption may be overcome by a preponderance of the evidence that the actual location of the use by the purchaser is not consistent with the terms of the contract or the taxpayer's books and records.

Subsection (d)(1)(B) provides that if the assignment cannot be made by subsection (d)(1)(A), then the location of the use of the intangible property shall be reasonably approximated by reference to the activities of the purchaser, limited to the jurisdictions where the purchaser will use the intangible at the time of the purchase, to the extent this information is available to the taxpayer. This rule assumes that the purchaser will use the intangible where it is doing business at the time of purchase. This rule also contains a limitation that the taxpayer cannot assign the use of the intangible to places where the purchaser does not conduct its business at the time of purchase.

Subsection (d)(1)(C) provides the final place of assignment as the billing address of the purchaser. This is a catch-all rule and only applies if assignment cannot be made under subsection (d)(1)(A) or (B).

Subsection (d)(1)(D) provides examples showing how the cascading rules in subsection (d)(1) operate. Example 1 involves a sale of 100% of the stock in a business and makes the assignment based upon where the assets controlled by the intangible are located and will be used by the purchaser. This is accomplished by reference to the apportionment factors of the subsidiary that is sold. This is an application of the subsection (d)(1)(A) rule. Example 2 illustrates an assignment under the second rule based upon the taxpayer's knowledge of where the purchaser was doing business under subsection (d)(1)(B). Example 3 illustrates circumstances when the final alternative, the purchaser's billing address, under subsection (d)(1)(C) would apply.

Subsection (d)(2) sets forth the rules for assigning receipts from the licensing, leasing, rental or other use of intangible property, as defined in subsection (b)(5), not including sales of intangible property provided for in paragraph (1).

Subsection (d)(2)(A), entitled "Marketing intangibles," provides the rules for the assignment of sales where a license is granted to use intangible property in connection with the marketing of goods, services or other items to customers in this state. The receipts from these types of licensing agreements are assigned to the location of the retail customers who purchased the goods, services or other items that are marketed in connection with the intangible property.

Subsection (d)(2)(A)1 sets forth the first rule of assignment that the contract between the taxpayer and the licensee or the taxpayer's books and records will establish the extent to which the goods are purchased by retail customers in this state, in which case the sales will be assigned to this state.

Subsection (d)(2)(A)2 provides that if the information is not available to assign the sales pursuant to subsection (d)(2)(A)1, the location of the use of the intangible property (the retail customers of the licensee) is to be reasonably approximated by reference to the activities of the taxpayer's purchaser (the licensee) to the extent such information is available to the taxpayer. Reasonable approximation can include a population proxy, but may only be based on population data where the licensee uses the intangible to market goods.

Subsection (d)(2)(A)3 provides a special rule where the licensee does not sell directly at retail and therefore neither the taxpayer nor the licensee would have information on where retail sales occur. Where the sale is at the wholesale level rather than to retail customers, then the taxpayer may use the percentage of this state's population to the total population of the geographic area in which the licensee markets its goods. A limitation is provided that the population of foreign countries can only be used if the intangible is materially used in marketing goods in a foreign country.

Subsection (d)(2)(B), entitled "Non-marketing and manufacturing intangibles," provides the rules for assignment of sales where a license is granted for the right to use intangible property in a manufacturing process or for another non-marketing purpose. This type of sale is assigned to the location where the intangible property is used, i.e. the manufacturing plant or other place of use, rather than the location of the ultimate consumer who purchases the manufactured product.

Subsection (d)(2)(B)1 provides that the primary rule that the contract between the taxpayer and its licensee, or the taxpayer's books and records, is presumed to indicate the extent of the use of the intangible property in this state. Either the taxpayer or the Franchise Tax Board may rebut this presumption by showing that the place of use is not shown by the contract or the taxpayer's books and records.

Subsection (d)(2)(B)2 provides the second rule of assignment that the location of the use of the intangible property is to be reasonably approximated by reference to the activities of the licensee to the extent this information is available to the taxpayer. This second rule only applies if the first rule cannot be applied.

Subsection (d)(2)(B)3 provides a third rule of assignment which is the state of the licensee's billing address. This rule only applies if the first two rules cannot be applied. This is a catch-all rule and only applies if assignment cannot be made under subsection (d)(2)(B)1 or 2.

Subsection (d)(2)(C), entitled "Mixed Intangibles," provides the segue for the rules for assignment of those sales where a license is granted for the right to use intangible property in both a marketing and manufacturing or other non-marketing purpose.

Subsection (d)(2)(C)1 provides that where the fees for the marketing are separately stated in the licensing contract from the fees for the manufacturing or other non-marketing purpose, then the fees shall be assigned based on that separate statement. However, if the separate statement is not reasonable, then the Franchise Tax Board may use a reasonable method that accurately reflects each use of the intangible property.

Subsection (d)(2)(C)2 provides that where the fees are not separately stated, then it is presumed that the fees are paid entirely for the intangible property in connection with the marketing of goods, services or other items. Either the taxpayer or the Franchise Tax Board is allowed to establish that the fee was not paid exclusively for marketing.

Subsection (d)(2)(D) provides examples for how to assign sales in connection with the licensing of intangible property in subsections (d)(2)(A), (B) and (C) above. Example 1 illustrates assignment pursuant to subsection (d)(2)(A)1 in connection with a marketing intangible where the licensing fees are based on a percentage of total products sold in each state. Example 2 illustrates assignment pursuant to subsection (d)(2)(A)2 in connection with a marketing intangible using a reasonable approximation method. Example 3 illustrates assignment pursuant to subsection (d)(2)(B)1 in connection with a non-marketing intangible using the taxpayer's contract and books and records. Example 4 illustrates an assignment pursuant to subsection (d)(2)(C)2 in connection with mixed intangible under an agreement which does not separately state marketing and manufacturing licensing fees. Example 5 illustrates assignment pursuant to subsection (d)(2)(C)1 in connection with a mixed intangible under an agreement that does separately state marketing and manufacturing licensing fees. Examples need to be added to show assignment pursuant to subsections (d)(2)(A)3, (d)(2)(B)2 and 3, and (d)(2)(C)1.

Subsection (e) provides that sales from the sale, lease, rental or licensing of real property is in this state if the real property is located in this state.

Subsection (f) provides that sales from the rental, lease, or licensing of tangible personal property are in this state if the tangible personal property is located in this state. There is an example provided.

Subsection (g) provides introductory language to the special rules for this regulation.

Subsection (g) (1) states that the Franchise Tax Board must consider the effort, expense and resources required of a taxpayer to obtain the necessary information to assign sales under RTC section 25136, subdivision (b). The Franchise Tax Board may accept a reasonable approximation where appropriate such as when a smaller business cannot develop the

necessary data from its financial records kept in the regular course of its business. An example is provided.

Subsection (g)(2) provides that in determining customers' or licensee's use of intangible property in connection with "Marketing Intangibles" under subsection (d)(2)(A)2, factors to be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold in each state, or other data including population. This language provides guidance as to how to "reasonably approximate" marketing intangibles.

Subsection (g)(3) segues for special rules in determining reasonable approximation of the location of the market for the benefit of the services or the location of the use of intangible property.

Subsection (g)(3)(A) states that once a taxpayer has used a particular reasonable approximation method under any provision of the regulation, then the taxpayer must continue to use that method in subsequent taxable years. To use a different method the taxpayer must seek permission of the Franchise Tax Board.

Subsection (g)(3)(B) states that the method of reasonable approximation must reasonably relate to the income of the taxpayer. For instance, if the taxpayer includes countries in its reasonable approximation for which no sales exist, then the taxpayer's method for reasonable approximation does not reasonably relate to its income.

Subsection (g)(4) incorporates, with appropriate modifications, provisions under CCR section 25137 into the regulations under section 25136(b). Subsection (g)(4)(A) provides that references in the regulations promulgated under RTC section 25137 that refer to RTC section 25136 and CCR section 25136 shall, for purposes of section 25136(b), refer to RTC section 25136, subdivision (b), and CCR section 25136(b). Subsection (g)(4)(B) states that CCR section 25137(c)(1)(C) [Special Rules. Sales Factor] is not applicable. Subsection (g)(4)(C) states that the provisions in CCR section 25137-3 [Franchisors] that relate to the taxpayer not being taxable in a state are not applicable. Subsection (g)(4)(D) states that the provisions in CCR section 25137-4.2 [Banks and Financials] that relate to income-producing activity and costs of performance and throwback are not applicable. Subsection (g)(4)(E) states that the provisions in CCR section 25137-12 [Print Media] that relate to a taxpayer not being taxable in another state and the sale's inclusion in the sales factor numerator if the property had been shipped from this state is not applicable.

DISCLOSURES REGARDING THE PROPOSED REGULATORY ACTION

Mandates on local agencies and school districts: None.

Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed under Part 7, commencing with Government Code section 17500, of Division 4: None.

Other non-discretionary cost or savings imposed upon local agencies: None.

Cost or savings in federal funding to the state: None.

Significant statewide adverse economic impact directly affecting business including the ability of California businesses to compete with businesses in other states: None.

Cost to directly affected private persons/businesses potential: The Board is not aware of any cost impacts that a representative, private person or business would necessarily incur in reasonable compliance with the proposed action.

Significant effect on the creation or elimination of jobs in the state: The Board is required to assess any impact the regulations may have on the creation or elimination of jobs in the State of California, the creation of new businesses, the elimination of existing businesses, and the expansion of businesses currently operating in the state. The Board has made an initial determination that the proposed regulation will not have an effect on any of the above, but invites interested parties to comment on this issue.

Significant effect on the creation of new businesses or elimination of existing businesses within the state: None.

Significant effect on the expansion of business currently doing business within the state: None.

Effect on small business: The department has made an initial determination that the adoption of the proposed regulation will not affect small businesses as generally multi-state corporations are not considered small businesses and this proposed regulation will apply only to multi-state corporations. However, the Board invites public comments on the question of economic impact on small businesses.

Significant effect on housing costs: The Board is not aware of any significant effect on housing costs that will be incurred by reasonable compliance with the proposed regulation.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code section 11346.5, subdivision (a)(13), the Board has determined that no reasonable alternative considered by the Board or that has otherwise been identified and brought to the attention of the Board would be more effective in carrying out the purpose of this proposed regulation or would be as effective and less burdensome to affected private persons than the proposed action.

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATIONS

An initial statement of reasons has been prepared setting forth the facts upon which the proposed regulatory action is based. The statement includes the specific purpose of the proposed regulatory action and the factual basis for determining that the proposed regulatory action is necessary.

The express terms of the proposed text of the regulation, the initial statement of reasons and the rulemaking file are prepared and available upon request from the agency contact person named in this notice. When the final statement of reasons is available, it can be obtained by contacting the agency officer named below, or by accessing the Franchise Tax Board's website identified below.

CHANGE OR MODIFICATION OF ACTIONS

The proposed regulatory action may be adopted after consideration of any comments received during the comment period.

The regulation may also be adopted with modifications if the changes are nonsubstantial or the resulting regulation is sufficiently related to the text made available to the public so that the public was adequately placed on notice that the regulation as modified could result from that originally proposed. The text of the regulation as modified will be made available to the public at least 15 days prior to the date on which the regulation is adopted. Requests for copies of any modified regulation should be sent to the attention of the agency officer named below.

ADDITIONAL COMMENTS

If you plan on attending or making an oral presentation at the regulation hearing, please contact the agency officer named below.

The hearing room is accessible to persons with physical disabilities. Any person planning to attend the hearing who is in need of a language interpreter or sign language assistance should contact the officer named below at least two weeks prior to the hearing so that the services of an interpreter may be arranged.

CONTACT

All inquiries concerning this notice or the hearing should be directed to Colleen Berwick at Franchise Tax Board, Legal Division, P.O. Box 1720, Rancho Cordova, CA 95741-1720; Telephone (916) 845-3306; Fax (916) 845-3648; E-Mail: colleen.berwick@ftb.ca.gov. In addition, all questions on the substance of the proposed regulation can be directed to Melissa Potter; Telephone (916) 845-7831. This notice, the initial statement of reasons and express terms of the proposed regulation are also available at the Franchise Tax Board's website at www.ftb.ca.gov.

INITIAL STATEMENT OF REASONS FOR THE ADOPTION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 25136

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS

The provisions in California Revenue and Taxation Code (RTC) section 25136, subdivision (b), were originally enacted in 2009 and are operative for taxable years beginning on or after January 1, 2011. Subdivision (b) of RTC section 25136 requires a market-based approach for assignment of sales of other than tangible personal property for all taxpayers who elect to use single sales factor apportionment formula under RTC section 25128.5, also enacted in 2009 and operative for taxable years beginning on or after January 1, 2011. There is no existing regulation under RTC section 25136, subdivision (b), to explain to taxpayers how the market based assignment of sales of other than tangible personal property will operate. Subdivision (c) of RTC section 25136 specifically provides that "[t]he Franchise Tax Board may prescribe those regulations as necessary or appropriate to carry out the purposes of subdivision (b)."

SPECIFIC PURPOSE OF THE MODIFICATION OF THE REGULATION

The purpose of proposed California Code of Regulations (CCR) section 25136(b) is to instruct multistate taxpayers who make a single-sales factor election on how to assign sales of other than sales of tangible personal property based on the location of the taxpayer's market. The regulation will achieve that purpose by providing definitions, guidelines, and examples that provide information beyond that provided by the underlying code section.

Currently, CCR section 25136 generally provides that gross receipts from sales of other than tangible personal property are assigned to this state based on income-producing activity/cost of performance rules. Those taxpayers who do not elect a single-sales factor formula under RTC section 25128.5 and CCR section 25128.5 must assign sales of other than tangible personal property pursuant to subdivision (a) of RTC section 25136 and the existing regulation provisions that give guidance for the operation of the income-producing activity/cost of performance rules. These existing regulation provisions will be renumbered CCR section 25136(a) to correspond with the underlying corresponding statute, RTC section 25136, subdivision (a), as part of this rulemaking project.

NECESSITY

During 2009, the California Legislature adopted a new RTC section 25136, now numbered RTC section 25136, subdivision (b), operative for taxable years beginning on or after January 1, 2011. During 2010, the California Legislature amended RTC section 25136 to retain the income-producing/cost of performance rules for assignment of sales of other than tangible personal property for taxpayers who do not make a single-sales factor election. As a result, the statute is currently divided into two parts: for those taxpayers who do not make a single-sales factor election, subdivision (a) of RTC section 25136 applies and provides the income-producing activity/cost of performance rules for assignment of sales of other than tangible personal property, and for those taxpayers who do make a single-sales factor apportionment formula election, subdivision (b) of RTC section 25136 applies and provides the market

based rules for assignment of sales of other than tangible personal property. Subdivision (c) of RTC section 25136 specifically authorizes the Franchise Tax Board to issue necessary or appropriate regulations regarding the assignment of sales of other than tangible personal property based on market rules under subdivision (b) of RTC section 25136. Since subdivision (b) of RTC section 25136 lacks specificity regarding assignment of sales of other than tangible personal property based on the location of where the benefit of the services is received or the location of the use of intangible property, a regulation is necessary to inform taxpayers how the market-based rules are to be applied.

There are many issues to be addressed by way of regulation so that taxpayers understand the meaning of the terms and their application in various situations. Some of these issues include: how is it determined where a customer received the benefit of services or where the intangible property was used, what documentation is available to the taxpayer, what happens if there is no documentation available to the taxpayer, what should be the order of the best evidence, and whether there are any special circumstances that should be addressed by special rules.

The Franchise Tax Board looked to existing statutes and regulations of all states which have adopted similar market rules to use some of the definitions and terms as a model. These states' statutes and regulations are listed in the 50 state analysis which was posted on the Franchise Tax Board's website prior to the first interested parties meeting on February 10, 2010. The Franchise Tax Board also conducted two other interested parties meetings in 2010 in order to obtain input from taxpayers and other members of the interested public. Explanations for draft language were provided in advance of those meetings.

Subsection (a) of the regulation states the general rule that sales of other than tangible personal property are in this state if the taxpayer's market is in this state. These market-based rules for assignment of sales of other than tangible personal property are in addition to those described in RTC section 25135, which contains the rules for assignment of sales of tangible personal property.

Subsection (b) defines terms contained within the regulation. These definitions were primarily modeled after definitions utilized by other states and discussed at the three interested parties meetings held in February, July and November 2010.

In subsection (b)(1) the term "benefit of a service is received" is defined as the location where the taxpayer's customer has either directly or indirectly received value from the delivery of a service. The definition is provided to explain the meaning of the term as used in the statute. Where the benefit is received is determined by the use made of the service by the taxpayer's customer.

The examples in subsection (b)(1) are provided to illustrate where the benefit of a service is received for purposes of the statute in specific situations. The examples were modeled from those utilized by other states with similar statutes and/or regulations including Georgia, Illinois, Iowa, Ohio and Wisconsin.

In subsection (b)(2) the term "service" is defined as activities engaged in by one for another for consideration. The definition excludes activities outside the taxpayer’s regular course of

business as well as activities undertaken for other members of the taxpayer's unitary business. These exclusions are consistent with the provisions of CCR section 25134 which states only the gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business shall be included in the sales factor and with CCR section 25106.5-1 which eliminates transactions between members of a unitary business.

Subsection (b)(3) defines the term "cannot be determined" as meaning that the taxpayer's records, or the records of the taxpayer's customer available to the taxpayer, do not indicate the location where the benefit of the service was received or where the intangible property was used. Comments at the interested parties meetings expressed concern as to how to determine where the benefit of the service was received or location of the use of intangible property in the event there was no available documentation that provided that information. As a result, it was decided that there should be a reasonable alternative method which would reliably estimate the location of the market in the event actual taxpayer records do not exist. The alternative method is a reasonable approximation of the taxpayer's market and is defined and discussed below.

In subsection (b)(4) the definition of "commercial domicile" is defined as the place where the trade or business is directed or managed by the taxpayer. It is based on RTC section 25120, subdivision (b).

Subsection (b)(5) lists, without limitation, twenty-two (22) specific terms and ends with the catch-all, "other similar intangible assets." This definition is based on a combination of various other states' definitions, including Georgia and Illinois. Comments received at the first interested parties meeting indicated that taxpayers wanted to know with a degree of certainty what "intangible property" means in connection with this regulation. Listing items provides certainty with respect to the items listed but does not preclude other items from being included.

In subsections (b)(5)(A), (B) and (C) the terms "marketing intangible," "non-marketing and manufacturing intangible," and "mixed intangible" are defined based on Massachusetts' law on assignment of intangible property. A "marketing intangible" is intangible property whose primary value lies in the marketing of the intangible property. A "non-marketing and manufacturing intangible" is intangible property where the value of the intangible property lies predominately in its non-marketing or manufacturing use. "Mixed intangible" is intangible property whose value includes both the license of a marketing intangible property and license of a non-marketing or manufacturing intangible property. Subsection (d)(2) of this regulation provides different rules of numerator assignment for the use of intangibles based upon these three categories of intangibles, so that it is necessary to define what is included in each category. The reasons for making different assignments on the basis of the concepts of marketing and manufacturing intangibles are explained below in the discussion of the provisions themselves.

In subsection (b)(6) the term "intangible personal property is used" is defined as the location where the intangible property is employed by the taxpayer's customer or licensee. This language is based on RTC section 25127.

In subsection (b)(7) the term "reasonably approximated" is defined by reference to the business of the taxpayer's customer. Reasonable approximations are used when location cannot be determined by reference to the contract between the taxpayer and its customer or the taxpayer's books and records. Discussion at the three interested parties meetings indicated that there needed to be an alternative way to establish a taxpayer's market where the primary source of evidence, i.e. the contract or the taxpayer's books and records, did not establish the taxpayer's market for the sale. The concept of "reasonable approximation" is a reliable alternative if the approximation is done in a way that takes into account the business activities of the taxpayer's customer. Specific information should be used over general information for reasonable approximations. Population can be used as a basis for reasonable approximations.

In subsection (b)(8) the term "to the extent" is defined to make clear that a receipt is to be divided proportionally between states when it relates to activities in more than one state. Comments at the three interested parties meetings held in 2010 indicated that the location where the benefit of the service is received and the location of the use of the intangible property should be assigned only to California in direct proportion to what was received or located in California compared with other states. This provision is consistent with the intent of the underlying statute, RTC section 25136, subdivision (b), which specifically states "(1) Sales from services are in this state *to the extent* the purchaser of the service received the benefit of the service in this state. (2) Sales from intangible property are in this state *to the extent* the property is used in this state." [Emphasis added.] This language is also consistent with other states' statutes and/or regulations which have adopted a similar market based rule for assignment of sales to the extent that services are received and intangible property is used in other states. The rule provided by RTC section 25136, subdivision (b), is different from the rule provided in RTC section 25136, subdivision (a), which assigns all of a receipt to the state with the preponderance of the activities.

Subsection (c) addresses assignment of sales from services to the extent that the benefit of the service is received in this state by the taxpayer's customer. Comments at the interested parties meetings of February and July 2010 indicated a consensus that rules assigning sales to individual customers should be different than corporate or other business entity customers. The rationale was that where the customer was an individual that customer would most likely receive the benefit of the service at his or her home address and the home address would most of the time be the billing address, whereas for a corporate or business customer the location of receipt of the benefit of the services could be in a number of places, not necessarily the billing address. As a result, there are two different sets of cascading rules: one for individuals and one for corporate or other business entities. This introductory language mirrors the language of the underlying statute, RTC section 25136 subdivision (b), and is segue to the cascading rules below.

Subsection (c)(1) sets forth the billing address as the primary rule for assigning sales of services where the taxpayer's customer is an individual. Subsection (c)(1) also provides a safe harbor rule for taxpayers so that if the taxpayer uses the individual customer's billing address as the mechanism for assignment of the sales, then the Franchise Tax Board must accept this presumptively correct assignment. This language was added because comments at the interested parties meetings indicated concern that the Franchise Tax Board's auditors

would attempt to overcome the presumption of billing address by looking at individual customers one by one and that, in light of the small amounts of money at stake for any individual customer, this would be overly burdensome for taxpayers. This “safe harbor” will not prevent the Franchise Tax Board from auditing to ensure that billing address was in fact the method utilized and that it was done correctly.

Subsection (c)(1)(A) sets forth the secondary rule for assignment which is applicable only when the taxpayer establishes by a preponderance of evidence that either the contract between the taxpayer and its customer or the taxpayer's books and records kept in the regular course of its business indicate the extent to which the benefit of the service was received in this state. If the taxpayer uses this alternative method of assigning the sales, this subsection allows the Franchise Tax Board the right to audit the alternative method to determine whether or not the taxpayer has overcome the presumption that the benefit of the service was received at the customer’s billing address and also that the taxpayer's method reasonably reflects where the benefit of the service was received by the taxpayer's customers. It was agreed by both members of the public and staff of the Franchise Tax Board at the November 8, 2010 interested parties meeting that the Franchise Tax Board should have the right to audit any alternate method to the safe harbor rule used by the taxpayer in the event the taxpayer chose to not avail itself of the safe harbor rule.

If the assignment cannot be determined under the alternatives set forth in subsections (c)(1) and (c)(1)(A), then subsection (c)(1)(B) states the determination of the location shall be reasonably approximated. As outlined above in the definitional language, this alternative method was discussed at the interested parties meetings as the best alternate where there is no available documentation to determine the location where the benefit of the services was received or if available documentation indicated that the location of the benefit of the service was received in a different place than indicated by the contract or the taxpayer's books and records.

Subsection (c)(1)(C) provides examples illustrating how the cascading rules in subsection (c)(1) operate. Example 1 illustrates assignment under subsection (c)(1). Example 2 provides an example of when the billing address presumption is overcome and assignment under subsection (c)(1)(A) is proper. Example 3 illustrates when the billing address presumption is not overcome by the taxpayer and therefore assignment under subsection (c)(1) is proper. Taxpayers at the interested parties meetings requested that an example be provided for each of the cascading rules. These examples were discussed at length at the interested parties meetings of 2010. One more example needs to be added to illustrate assignment by reasonable approximation under (c)(1)(B).

Subsection (c)(2) addresses assignment of sales where the benefit of the services was received by corporate or other business entities. The majority of members of the public at the interested parties meetings concurred that the cascading rules set forth below would be the most logical step-down approach to assignment of sales to corporate or other business entities because taxpayers, depending on whether they are small or large, sophisticated or simple, will have different levels of available information. Some taxpayers will have extensive contract provisions or books and records indicating the location where the benefit of the service was received, and other taxpayers may not have the requisite information in

either a contract, if they have one at all, or in their books and records to establish the location where the benefit of the service was received. As a result, the cascading rules set forth below were developed in order of the best evidence or data. The cascading rules also potentially avoid the situation of nowhere sales where sales escape inclusion in any state's apportionment formula. Another concern voiced by both taxpayers and Franchise Tax Board auditors alike was the fear that either might have the ability to "cherry pick" the "option" that increased or decreased the sales assigned to California, which in turn would increase or decrease the overall tax assessment, depending upon the desired effect of the party choosing the option. Consequently, the first cascading rule is set forth as a presumption that may only be overcome by a preponderance of the evidence. The effect is that a taxpayer or the Franchise Tax Board may only get to the second cascading rule of reasonable approximation if the taxpayer or the Franchise Tax Board overcomes the presumption that the contract or the taxpayer's books and records establish the location of where the benefit of the services is received. Likewise, the taxpayer or the Franchise Tax Board may only get to the third cascading rule of the location from which the customer made the order if the location of where the benefit was received cannot be reasonably approximated. Finally, the taxpayer or the Franchise Tax Board may not use the last resort rule of the billing address unless the ordering location cannot be determined.

Subsection (c)(2)(A) sets forth the first rule of assignment which provides that the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records are presumed to establish the location where the benefit of the service is received, notwithstanding the billing address of the taxpayer's customer. As discussed above, participants at the interested parties' meetings felt that the contract or the taxpayer's books and records was the best and most reliable data and therefore should be the primary sources of determining the location where the benefit of the service was received. The presumption may be overcome by a preponderance of the evidence that the contract and the books and records do not indicate the actual location of where the benefit of the service was received.

Subsection (c)(2)(B) sets forth the second rule of assignment that the location where the benefit is received is to be reasonably approximated by reference to the activities of the taxpayer's customer's activities. The second rule only applies if the presumption in favor of the first assignment rule is overcome. Again, interested parties meetings participants felt that in the absence of best evidence, i.e. the contract or the taxpayer's books and records, a reasonable approximation of the location of the taxpayer's market would be the best alternate method of establishing the taxpayer's market.

Subsection (c)(2)(C) sets forth the third rule of assignment which is the location from which the taxpayer's customer placed the order for the service. This rule only applies if where the benefit was received cannot be determined under the first two rules provided in subsections (c)(2)(A) or (B). There will be some situations when the contract between the taxpayer and its customer, or the taxpayer's books and records, will not in fact indicate the location where the benefit of the services was received and where the location where the benefit of the services was received cannot be reasonably approximated. This provision is the third-in-line cascading rule that seeks to establish the taxpayer's market in the event of a lack of best evidence, i.e. the contract, the taxpayer's books and records, and the inability to reasonably

approximate the location of the taxpayer's market. This alternative is only available in the event the first two cascading rules cannot determine the location where the benefit of the service was received.

Subsection (c)(2)(D) sets forth the final rule of assignment: taxpayer's customer's billing address. This final rule is a catch-all when none of the provisions above can establish the location where the benefit of the services was received.

Subsection (c)(2)(E) gives examples showing how the cascading rules in subsection (c)(2) operate. Examples I, 2 and 3 illustrate assignment under subsection (c)(2)(A) using a taxpayer's books and records. Example 4.a illustrates assignment under subsection (c)(2)(A) using a taxpayer's books and records and example 4.b illustrates assignment under subsection (c)(2)(B) by reasonably approximating where the benefit of the services was received. Example 5.a illustrates assignment under subsection (c)(2)(C) when the first three cascading rules are unavailable and the sale must be assigned to the location from where the services were ordered. Example 5.b illustrates subsection (c)(2)(D) where the first four cascading rules are unavailable and the sale must be assigned to the customer's billing address. Members of the public at the interested parties meetings wanted examples for each cascading rule. These examples were discussed at the interested parties meetings.

Subsection (d) addresses assignment of sales from intangible property. Sales are assigned to this state to the extent the intangible property is used in this state. This introductory provision mirrors the language of RTC section 25136, subdivision (b). It is a segue to the cascading rules set forth below. A distinction is made in this regulation between the complete transfer of all rights in the intangible property and the lease or other use of intangible property. Where there is a complete transfer of rights, usually the taxpayer has no access to information as to what its purchaser does with the intangible property after the purchase. On the other hand, where the intangible property is leased or put to other similar use, the taxpayer in many circumstances will know what is being done with the intangible property.

In many cases, the licensee pays a fee to the licensor based on a percentage of the sales of the tangible personal property produced by the customer that contains the licensed intangible. To verify the accuracy of the fee paid, the licensor may have access to this information. Because of this on-going relationship between the taxpayer and its customer, the taxpayer may be able to receive, or have the right to receive, information regarding the "use" of its property. This may include the ability to have the licensee provide information regarding its sales of the products manufactured pursuant to the licensing agreement. Therefore the rules for the sales from the use, licensing, lease or rental of intangible property contain a look-through from the manufacturer to the ultimate customer who buys the product which is produced at least in part with the technology of the licensor in order to properly assign the royalty receipts. This provision is consistent with other states who assign sales of intangible property to the ultimate customer: Indiana, Kentucky, Massachusetts, Missouri, Minnesota, North Carolina, and Wisconsin. As a result of the distinctions in a sale of intangible property where a complete transfer of all property rights has been made and a sale of intangible property where the property is leased or otherwise used, the regulation contains different cascading rules for each circumstance. The series of cascading rules of

assignment recognize the extent to which the taxpayer has knowledge of where the purchaser will use the intangible property.

Subsection (d)(1) addresses assignment of sales from intangible property where a complete transfer of all property rights for a jurisdiction or jurisdictions has been made.

Subsection (d)(1)(A) sets forth the first assignment rule for a sale where a complete transfer of all rights in intangible property has occurred. It provides that if the contract between the taxpayer and the purchaser indicate the extent of the location[s] where the purchaser will use intangible property at the time of purchase, then the assignment will be on that basis. Comments at the interested parties meetings indicate that the contract or the taxpayer's books and records is the best evidence of where it is intended that the intangible property will be used at the time of the transfer. Subsection (d)(1)(A) continues by stating that if the contract or the taxpayer's books and records do not specify where the purchaser will use the property, then the use the taxpayer made of the intangible property prior to the purchase will be used. This is based upon an assumption that the purchaser will use the property where the taxpayer had used it. If the transfer of ownership is for use in limited jurisdictions the contract will so provide. The presumption may be overcome by a preponderance of the evidence that the actual location of the use by the purchaser is not consistent with the terms of the contract or the taxpayer's books and records.

Subsection (d)(1)(B) provides that if the assignment cannot be made by subsection (d)(1)(A), then the location of the use of the intangible property shall be reasonably approximated by reference to the activities of the purchaser, limited to the jurisdictions where the purchaser will use the intangible at the time of the purchase, to the extent this information is available to the taxpayer. This rule assumes that the purchaser will use the intangible where it is doing business at the time of purchase. This rule also contains a limitation that the taxpayer cannot assign the use of the intangible to places where the purchaser does not conduct its business at the time of purchase. One way to estimate where the intangible will be used is to assume an even spread of use based upon the population of the jurisdictions where the purchaser conducts its business. If population is the reasonable approximation used, then the population must be the U.S. population unless the intangible property is currently being materially used in other parts of the world and it can be shown that the purchaser will continue to do so. If this can be shown, then, the population of countries where the intangible property is being materially used shall be added to the U.S. population. This limitation is provided to avoid the taxpayer estimating the use of the intangible on a worldwide basis when the purchaser does not currently operate throughout the world, even if the transfer of title gives the right to the purchaser to use the intangible everywhere.

Subsection (d)(1)(C) provides the final place of assignment as the billing address of the purchaser. This is a catch-all rule and only applies if assignment cannot be made under subsection (A) or (B).

Subsection (d)(1)(D) provides examples showing how the cascading rules in subsection (d)(1) operate. Example 1 involves a sale of 100% of the stock in a business and makes the assignment based upon where the assets controlled by the intangible are located and will be used by the purchaser. This is accomplished by reference to the apportionment factors of

the subsidiary that is sold. This is an application of the subsection (d)(1)(A) rule. Example 2 illustrates an assignment under the second rule based upon the taxpayer's knowledge of where the purchaser was doing business under subsection (d)(1)(B). Example 3 illustrates circumstances when the final alternative, the purchaser's billing address, under subsection (d)(1)(C) would apply. Members of the public at the interested parties meetings requested examples for each cascading rule. These examples were discussed at the interested parties meetings.

Subsection (d)(2) addresses assignment of sales of intangible property where the property is licensed, leased, rented or otherwise used. This introductory language segues to the cascading rules. Assignment is based on three different criteria: whether the value lies in the marketing of the intangible property, whether the value is in a non-marketing or manufacturing purpose, or whether the value is a mixture of marketing and non-marketing or manufacturing purposes. These distinctions, which are discussed at length in the definitional section, are based on a Massachusetts law for assignment of sales where intangible property is leased or otherwise similarly used. Members of the public at the interested parties meetings felt the distinctions and different assignment provisions based on the distinctions were a better and reasonable alternative to the blanket assignment of all license-type sales either to the ultimate customer or alternatively to the licensee.

Subsection (d)(2) sets for the rules for assigning receipts from the licensing, leasing, rental or other use of intangible property, as defined in subsection (b)(5), not including sales of intangible property provided for in subsection(d)(1).

Subsection (d)(2)(A), entitled "Marketing intangibles" provides the rules for the assignment of sales where a license is granted to use intangible property in connection with the marketing of goods, services or other items to customers in this state. Because the value of these types of intangible are primarily derived from their use in marketing underlying products to consumers, the receipts from these types of licensing agreements are assigned to the location of the retail customers who purchased the goods, services or other items that are marketed in connection with the intangible property. For example, a towel with a licensed cartoon character affixed to it sells primarily because of the cartoon character and not simply because it is a towel. Therefore, the licensee’s use of the intangible, and the assignment of the sale from that license by the licensor, should be assigned to the location where the towel with the cartoon character affixed to it is sold, i.e. the location of the retail customer. This approach is preferable to rules that assign receipts from licenses to where the product is manufactured because the location of manufacture is not the true use of the intangible that gives rise to the license fees. The location of the licensee reflects where the licensee employs labor and capital, but this does not fit with the intention of the new statutory scheme. Because the revisions to RTC section 25136 are intended to find, as best as can be determined, the market being exploited in California, the purchase of the underlying products containing the intangibles in California should be recognized in assigning the licensee fee sales. In most cases the license contract calls for a percentage of sales to be paid as the fee, so therefore it is the underlying sales of products that really reflects the market.

Subsection (d)(2)(A)1 sets forth the first rule of assignment that the contract between the taxpayer and the licensee or the taxpayer's books and records will establish the extent to which the goods are purchased by retail customers in this state and thus whether the sales will be assigned to this state. Members of the public at the interested parties meetings concur that the best evidence for determination of assignment of receipts under this regulation is the contract or the taxpayer's books and records.

Subsection (d)(2)(A)2 provides that if the information is not available to assign the sales pursuant to subsection (d)(2)(A)1, the location of the use of the intangible property (the retail customers of the licensee) is to be reasonably approximated by reference to the activities of the taxpayer's purchaser (the licensee) to the extent such information is available to the taxpayer. Reasonable approximation is a reasonable alternative for establishing the taxpayer's retail market where the contract and the taxpayer's books and records do not do so. Reasonable approximation can include a population proxy but only based on the population data where the licensee uses the intangible to market goods. Several states including Illinois use population data as a proxy for the establishment of the ultimate customer. Comments at interested parties meetings indicate that population is a reasonable proxy for establishing a taxpayer's retail market provided that the population used be in geographic areas where the taxpayer actually has sales.

Subsection (d)(2)(A)3 provides a special rule where the licensee does not sell directly at retail and therefore neither the taxpayer nor the licensee would have information on where retail sales occur. Where the sale is at the wholesale level rather than to retail customers, then the taxpayer may use the percentage of this state's population to the total population of the geographic area in which the licensee markets its goods. A limitation is provided that the population of foreign countries can only be used if the intangible is materially used in marketing goods in a foreign country. Population data is considered by the public and the staff of the Franchise Tax Board alike to be a reasonable proxy for establishing a taxpayer's market in this circumstance.

Subsection (d)(2)(B) entitled "Non-marketing and manufacturing intangibles" provides the rules for assignment of sales where a license is granted for the right to use intangible property in a manufacturing process or for another non-marketing purpose. This type of sale is assigned to the location where the intangible property is used, i.e. the manufacturing plant or other place of use, rather than the location of the ultimate consumer who purchases the manufactured product. The premise for this method of assignment is that the licensee's use for these types of intangibles is primarily in the manufacturing activity itself rather than in the marketing of the product produced. In addition, taxpayers with these types of licensing sales will likely be unable to establish the ultimate retail market because licenses of technology to manufacturers can be used in a variety of different ways for a variety of different products and in some circumstances the end-product is not even manufactured by the licensee of the technology. As a result, retail customer information is often not available to the licensee (purchaser) of the taxpayer's license. This rule parallels RTC section 25127, which provides rules for the assignment of nonbusiness income arising from patents.

Subsection (d)(2)(B)1 provides that the primary rule that the contract between the taxpayer and its licensee, or the taxpayer's books and records, is presumed to indicate the extent of

the use of the intangible property is in this state. Either the taxpayer or the Franchise Tax Board may rebut this presumption by showing that the place of use is not shown by the contract or the taxpayer's books and records. Members of the public at the interested parties meetings concurred that the best evidence for determination of assignment of receipts under this regulation is the contract or the taxpayer's books and records.

Subsection (d)(2)(B)2 provides the second rule of assignment that the location of the use of the intangible property is to be reasonably approximated by reference to the activities of the licensee to the extent this information is available to the taxpayer. This second rule only applies if the first rule cannot be applied. Interested parties meetings participants felt that in the absence of best evidence, i.e. the contract or the taxpayer's books and records, a reasonable approximation of the location of the use of the intangible property would be the best alternate method of assignment of receipts under this regulation.

Subsection (d)(2)(B)3 provides a third rule of assignment which is the state of the licensee's billing address. This rule only applies if the first two rules cannot be applied. This is a catch-all rule and only applies if assignment cannot be made under subsection (d)(2)(B)1 or 2.

Subsection (d)(2)(C) entitled "Mixed Intangibles" provides the segue for the rules for assignment of those sales where a license is granted for the right to use intangible property in both a marketing and manufacturing or other non-marketing purpose.

Subsection (d)(2)(C)1 provides that where the fees for the marketing are separately stated in the licensing contract from the fees for the manufacturing or other non-marketing purpose, then the fees shall be assigned based on that separate statement. However, if the separate statement is not reasonable, then the Franchise Tax Board may use a reasonable method that accurately reflects each use of the intangible property. This language establishes that the taxpayer's contract will be taken at face value unless it is unreasonable.

Subsection (d)(2)(C)2 provides that where the fees are not separately stated, then it is presumed that the fees are paid entirely for the intangible property in connection with the marketing of goods, services or other items. Either the taxpayer or the Franchise Tax Board is allowed to establish that the fee was not paid exclusively for marketing. This provision is to encourage taxpayers to separately state in their licensing contracts their marketing fees from their non-marketing fees so that their marketing and non-marketing fees, as sales of intangible property, are accurately assigned under this regulation.

Subsection (d)(2)(D) provides examples for how to assign sales in connection with the licensing of intangible property in subsections (d)(2)(A), (B) and (C) above. Example 1 illustrates assignment pursuant to subsection (d)(2)(A)1 in connection with a marketing intangible where the licensing fees are based on a percentage of total products sold in each state. Example 2 illustrates assignment pursuant to subsection (d)(2)(A)2 in connection with a marketing intangible using a reasonable approximation method. Example 3 illustrates assignment pursuant to subsection (d)(2)(B)1 in connection with a non-marketing intangible using the taxpayer's contract and books and records. Example 4 illustrates an assignment pursuant to subsection (d)(2)(C)2 in connection with mixed intangible under an agreement which does not separately state marketing and manufacturing licensing fees. Example 5

illustrates assignment pursuant to subsection (d)(2)(C)1 in connection with a mixed intangible under an agreement that does separately state marketing and manufacturing licensing fees. These examples were based on other states' examples which states have similar statutory and/or regulatory language, including Massachusetts. Members of the public at the interested parties meetings wanted examples to show how each cascading rule works and the examples above were discussed at the interested parties meetings. Examples need to be added to show assignment pursuant to subsections (d)(2)(A)3, (d)(2)(B)2 and 3, and (d)(2)(C)1.

Subsection (e) provides that sales from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state. This rule is identical to the statutory provision, RTC section 25136, subdivision (b)(3), and requires no further elaboration.

Subsection (f) provides that sales from the rental, lease, or licensing of tangible personal property are in this state if the tangible personal property is located in this state. There is an example provided. This rule is identical to the statutory provision, RTC section 25136, subdivision (b)(4). No further elaboration is necessary.

Subsection (g) provides introductory language to the special rules for this regulation.

Subsection (g) (1) states that the Franchise Tax Board must consider the effort, expense and resources required of a taxpayer to obtain the necessary information to assign sales under RTC section 25136, subdivision (b). The Franchise Tax Board may accept a reasonable approximation where appropriate such as when a smaller business cannot develop the necessary data from its financial records kept in the regular course of its business. Comments received at the interested parties meetings indicated that taxpayers wanted a provision similar to Ohio's where taxpayers would not be required to go to considerable effort and expense to update their computer systems or other data in order to be in compliance with the new statute and this regulation. This provision is based on Ohio's similar provision. An example is provided. This example was discussed at the interested parties meetings.

Subsection (g)(2) provides that in determining customers' or licensee's use of intangible property in connection with "Marketing Intangibles" under subsection (d)(2)(A)2, factors to be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold in each state, or other data including population. This language provides guidance as to how to "reasonably approximate" marketing intangibles. It is based on a Wisconsin regulation in connection with determining the location of the use of intangible property.

Subsection (g)(3) segues for special rules in determining reasonable approximation of the location of the market for the benefit of the services or the location of the use of intangible property.

Subsection (g)(3)(A) states that once a taxpayer has used a particular reasonable approximation method under any provision of the regulation, then the taxpayer must continue to use that method in subsequent taxable years. To use a different method the

taxpayer must seek permission of the Franchise Tax Board. This provision was discussed in interested parties meetings by taxpayers who argued that as long as their method was reasonable, taxpayers ought to be able to continue that reasonable method. The Franchise Tax Board agreed that taxpayers should be consistent in their reasonable approximation method from year to year and felt that if the taxpayer chose to use a different method, then the Franchise Tax Board should be allowed to approve of the alternate method. Members of the public at the interested parties meetings did not disagree.

Subsection (g)(3)(B) states that the method of reasonable approximation must reasonably relate to the income of the taxpayer. For instance, if the taxpayer includes countries in its reasonable approximation for which no sales exist, then the taxpayer's method for reasonable approximation does not reasonably relate to its income. This provision is to ensure that reasonable approximation relates to where the taxpayer conducts its business. Members of the public at the interested parties meetings did not dispute the reasonableness of this provision.

Subsection (g)(4) incorporates, with appropriate modifications, provisions under CCR section 25137 into the regulations under RTC section 25136, subdivision (b). Subsection (g)(4)(A) provides that references in the regulations promulgated under RTC section 25137 that refer to RTC section and CCR section 25136 shall, for purposes of section 25136, subdivision (b), refer to RTC section and CCR section 25136, subdivision (b). Subsection (g)(4)(B) states that CCR section 25137(c)(1)(C) [Special Rules. Sales Factor] is not applicable. Subsection (g)(4)(C) states that the provisions in CCR section 25137-3 [Franchisors] that relate to the taxpayer not being taxable in a state are not applicable. Subsection (g)(4)(D) states that the provisions in CCR section 25137-4.2 [Banks and Financials] that relate to income-producing activity and costs of performance and throwback are not applicable. Subsection (g)(4)(E) states that the provisions in CCR section 25137-12 [Print Media] that relate to a taxpayer not being taxable in another state and the sale's inclusion in the sales factor numerator if the property had been shipped from this state is not applicable. These modifications, eliminating references to cost of performance and throwback rules, are in keeping with market-based rules of RTC section 25136, subdivision (b), which is operative for taxable years beginning on and after January 1, 2011. Members of the public and the Franchise Tax Board at the interested parties meeting agreed that these changes are appropriate under the new scheme of RTC section 25136, subdivision (b).

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDIES, REPORTS, OR DOCUMENTS

In drafting proposed Regulation section 25136(b), the Franchise Tax Board relied on its fifty (50) state analysis of other states' market-based statutory and regulatory rules and three interested parties meetings held in February, July and November of 2010. The Franchise Tax Board did not rely upon any other technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

The Franchise Tax Board has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed regulation, or would be

less burdensome with respect to affected private persons or small businesses than the proposed regulation. The proposed regulation pertains only to corporate taxpayers and therefore does not affect private individuals. In addition, it pertains only to multistate and multinational businesses and therefore will have little or no impact on small business.

ADVERSE ECONOMIC IMPACT ON BUSINESS

The Franchise Tax Board has determined that the proposed regulation under RTC section 25136, subdivision (b), will not have a significant adverse economic impact on business beyond the impact that the statute itself imposes, if any. The proposed regulation primarily explains to multistate corporations how to assign sales of other than tangible personal property based on market rules.

TITLE 18. FRANCHISE TAX BOARD
AMENDMENTS TO PROPOSED
REGULATION SECTION 25136, RELATING TO
SALES OF OTHER THAN TANGIBLE PERSONAL PROPERTY

A hearing was held on August 10, 2011, by Melissa Potter of the Franchise Tax Board Legal Division, the "hearing officer," on proposed amendments to California Code of Regulations, title 18, section 25136 (Regulation section 25136), which was noticed in the California Regulatory Notice Register on June 17, 2011.

Department staff reviewed the proposed regulation language and considered the comments submitted at and before the hearing. The hearing officer recommends that the proposed new regulation section number be renumbered for clarity to 25136-2. The hearing officer also recommends that (1) a definition be deleted as unnecessary and another definition be expanded to include limitations that appear in various subsections; (2) examples be added or changed to indicate how all cascading rules operate; (3) examples that follow the cascading rules be identified by the subsection to which they apply; (4) language be added or altered to clarify the provision or to maintain consistency in phraseology throughout this regulation and/or other California regulations; and (5) a provision be added to address how to assign the receipt where there has been a sale of an interest in a corporation or pass-through entity.

These nonsubstantial or sufficiently related changes (within the meaning of Govt. Code Section 11346.8) recommended by the hearing officer are reflected in the attachment hereto. These amendments to the regulation are reflected by underscore for additions and strikeout for deletions. Proposed changes to Regulation section 25136 are summarized below.

1. In a number of places, either a provision has been deleted in its entirety or new one has been inserted. For example, the definition of commercial domicile has been deleted (formally subsection (b)(4)). As a result, the numbering and/or lettering of the regulation subsections have changed in some cases. This is indicated by strikeout or underscore of the number or letter being removed and/or being added. The subsections referred to in these paragraphs refer to the newly assigned number or letter as assigned by this 15 day notice's proposed changes.

2. Many examples have been modified to identify the subsection to which they specifically relate, for instance "Benefit of a Service – Individuals, subsection (c)(1)(A)." This has been done for clarity purposes, in particular where there are examples that appear back-to-back to illustrate an entire set of cascading rules for a particular subsection. This addition is indicated by underscore of the term that identifies the subsection to which the example applies.

3. The regulation section number has been revised to read "25136-2." The regulation number itself was originally titled "25136(b)" to follow the numbering of the underlying statute for market-based rules of assignment of sales. However, in previous regulations, the Franchise Tax Board has used a dash-number system, i.e., California Code of Regulations, title 18, section 25137-1 et seq. This numbering system was adopted to avoid confusion with subsection "(a)" in the number of the regulation itself with a subsection "(a)" immediately following in the body of the regulation. As a result, this proposed new

regulation section number has been renumbered to "25136-2", with the "(b)" deleted. The cost of performance provisions in existing Regulation section 25136 will be renumbered to 25136-1 with a subsequent Form 100 change.

> §25136~~(b)~~ 2. Sales Factor. Sales Other than Sales of Tangible Personal Property in this State.

4. Subsection (a), In General, has been revised to add Revenue and Taxation Code section 25135 (sales of tangible personal property), and change the reference to Revenue and Taxation Code section "25136" to "25136(a)." Originally, this subsection was intended to define sales as other than those sales of tangible personal property under Revenue and Taxation Code section 25135 and sales determined under income-producing activity/cost of performance rules under Revenue and Taxation Code section 25136, subdivision (a). Instead, when drafted, Revenue and Taxation Code section 25135 was omitted entirely, and the income-producing activity/cost of performance rules were mistakenly referenced as Revenue and Taxation Code section "25136" and not "25136(a)." To clarify that assignment of both type sales are not governed by this regulation's market-based rules, a reference to Revenue and Taxation Code section 25135 for sales of tangible personal property was added and Revenue and Taxation Code section 25136 was identified correctly as "25136, subdivision (a)," to reference assignment of sales under the income producing activity/cost of performance rules.

> In General. Sales other than those described under Revenue and Taxation Code Sections ~~25136~~ 25135 and 25136, subdivision (a), are in this state if the taxpayer's market for the sales is in this state.

5. Subsection (b)(4), which provided the definition of "commercial domicile," has been deleted. In an earlier draft, commercial domicile appeared as one of the cascading rules. The only place where "commercial domicile" appears in the current draft is in some of the examples for the definition of "benefit of a service is received." The definition of commercial domicile has been deleted because it is no longer necessary and in order to avoid confusion as to whether it is one of the cascading rules.

> ~~(4) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.~~

6. Subsection (b) contains the definitions for the regulation's provisions. The terms being defined have been reorganized alphabetically such that "Benefit of the service is received" is (b)(1) and is followed by "Cannot be determined" as (b)(2), which is in turn followed by "Intangible property" at (b)(3), "Reasonably approximated" at (b)(4), "Service" at (b)(5), "The use of intangible property in this state" at (b)(6) and "to the extent" at (b)(7).

7. Subsection (b)(3)(B), which defines "non-marketing and manufacturing intangible," has been revised to include the language "or other non-marketing process" and insert the word "property" after the word "intangible." These changes were made so that the terms are accurately and consistently phrased throughout the regulation. Both terms should have been originally included in the definitional section "non-marketing and manufacturing intangible" but the language was inadvertently omitted.

(B) A "non-marketing and manufacturing intangible" includes, but is not limited to, the license of a patent, a copyright, or trade secret to be used in a manufacturing or other non-marketing process, where the value of the intangible property lies predominately in its use in such process.

8. Subsection (b)(3)(C), which defines "mixed intangible," was revised to list specific types of intangible property, i.e. "a patent, copyright, service mark, trademark, trade name, or trade secrets", and delete the general term "intangible property that includes both a license of a marketing intangible and a license of a non-marketing intangible." Listing specific types of intangible property is a preferable way to define intangible property rather than using general terms to define it. Also, the phrase "includes but is not limited to" has been inserted to make it clear that the list is non-exclusive. Lastly, an unnecessary space between the word "intangible" and a quote mark was removed.

(C) A "mixed intangible-" includes, but is not limited to, the license of a patent, copyright, service mark, trademark, trade name, or trade secrets ~~intangible property that includes both a license of a marketing intangible and a license of a non-marketing intangible~~ where the value lies both in the marketing of goods, services or other items as described in subparagraph (A) and in the manufacturing process or other non-marketing purpose as described in subparagraph (B).

9. Subsection (b)(4), which defines "reasonably approximated," a cascading rule for assignment of sales that appears in various subsections throughout this regulation, has been revised in several ways. In general, the definition has been broadened to indicate that reasonable approximation is limited to the jurisdiction or geographic area where the customer receives the benefit of the service or uses the intangible property. Also, if reasonable approximation is by population, it must be determined by U.S. population unless it can be shown by the taxpayer that the benefit is received or the intangible property is used materially in other parts of the world. These limitations originally appeared only in the reasonable approximation provisions for sales of intangible property but not in the definition or in the reasonable approximation provisions for sales of services. A commenter on this regulation suggested that at least the population language of the reasonable approximation provisions for sales of intangible property should be brought into the definitional language of reasonable approximation. Ultimately, it was felt that all limitations (not just the population limitations) that appeared in the reasonable approximation provisions for sales of intangible property should appear in the definition of reasonable approximation and apply to the entire regulation. As a result, all limitations now appear in the definition of "reasonable approximation" and have been deleted from the reasonable approximation provisions for sales of intangible property as redundant. The limitations apply when reasonably approximating both sales of services and sales of intangible property. Specific changes to the definition include the following.

First, the word "business" is exchanged for the word "activities." Originally, the term "reasonably approximated" was stated throughout the regulation with the proviso "that is consistent with the *activities* of the customer..." [emphasis added.] However, the definition originally read "that is consistent with the *business* of the customer..." [emphasis added.] Since some customers may not be business entities or a customer's business may be

irrelevant to the services rendered, it would be more appropriate to refer to the customer's "activities" in getting to the taxpayer's market.

Second, in other subsections of the regulation, reasonable approximation is to be determined "in a manner that is consistent with the activities of the customer" but limited by the proviso "to the extent such information is available to the taxpayer." This provision was intended to provide fairness to the taxpayer who may or may not have access to such information regarding its customer. However, while that language appeared throughout this regulation's provisions regarding reasonable approximation, that language did not appear in the definition. It has been inserted into the definition and removed from individual provisions as now redundant.

Third, geographic and/or jurisdictional limitations have been inserted for reasonably approximating where the benefit of the service has been received and the location of the use of the intangible property. The benefit of the service must be "substantially" received and the intangible property "materially" used in other parts of the world if those parts of the world are to be included in the population data for reasonable approximation. The purpose of such limitations is to ensure that only the actual market for the services or intangible property is considered in the reasonable approximation.

Fourth, population has been defined to be determined "by U.S. census data." This addition provides a method of determining population numbers. This change was made pursuant to a comment received for this regulation.

(4) "Reasonably approximated" means that, considering all sources of information other than the terms of the contract and the taxpayer's books and records kept in the normal course of business, the location of the market for the benefit of the services or the location of the use of the intangible property is determined in a manner that is consistent with the ~~business~~ activities of the customer to the extent such information is available to the taxpayer. Reasonable approximation shall be limited to the jurisdictions or geographic area where the customer or purchaser, at the time of purchase, will receive the benefit of the services or use the intangible property, to the extent such information is available to the taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population as determined by the most recent U.S. census data. If it can be shown by the taxpayer that the benefit of the service is being substantially received or intangible property is being materially used in other parts of the world, then the populations of those other countries where the benefit of the service is being substantially received or the intangible property is being materially used shall be added to the U.S. population. Information that is specific in nature is preferred over information that is general in nature.

10. Subsection (b)(6), which originally defined the term "Intangible personal property is used," has been revised so that the term being defined is worded exactly as it appears throughout the language in subsection (d). As a result, "intangible personal property is used" has replaced with "the use of intangible property in this state". In addition, the definition has been expanded to address new provisions, subsections (d)(1)(A)1 and (d)(1)(A)1.a and b, which have been added to the sale of intangible property in the case where the stock of a

corporation or an interest in a pass-through entity has been sold. Thus, language has been added to the definition to state that the location of the use of the intangible property is the location of the use of the underlying assets of the business entity sold.

(6) ~~"Intangible personal property is used"~~ "[T]he use of intangible property in this state" means the location where the intangible property is employed by the taxpayer's customer or licensee. In the case of the complete transfer of all property rights in stock of a corporation or interest in a pass-through entity, the location of the use of the stock of the corporation or interest in the pass-through entity is the location of the use of the underlying assets of the corporation or pass-through entity.

11. Subsections (c)(1) and (c)(1)(A) previously provided the first cascading rule for the assignment of sale of services to individuals. Now, (c)(1) has been revised so that it is a segue to the cascading rules for assignment of sales of services to individuals, which now appear below it in subsections (c)(1)(A) and (B). This format is cleaner and clearer: all cascading rule subsections are contained within the same subsection format, i.e. (c)(1)(A) and (c)(1)(B), and not as they were previously set forth, subsections (c)(1) and (c)(1)(A). Also, this format is consistent with those provisions for cascading rules in subsection (d) for sales of intangible property. The following specific changes have been made.

First, "receipt of" has been inserted in front of the words "the benefit of the service" to be consistent with the statutory language as well as other provisions of this regulation. Second, "determined as follows:" has been added to indicate this subsection as the segue for the cascading rules to come under subsections (c)(1)(A) and (B). Third, the language of the first cascading rule has been deleted.

(1) In the case where an individual is the taxpayer's customer, receipt of the benefit of the service shall be ~~presumed to be received at the billing address of the taxpayer's customer, as determined at the end of the taxable year. If the taxpayer uses the customer's billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this assignment~~ determined as follows:

12. Subsection (c)(1)(A) now contains the first cascading rule of assignment to the customer's billing address, previously set forth in subsection (c)(1). To be consistent with other subsections of this regulation, the subsection starts with "The location of the benefit of the service..." Then, the cascading rule is inserted immediately preceding the original language of subsection (c)(1)(A), which provided the method for overcoming the presumption that the billing address is the location where the benefit of the services is received.

Other modifications have been made to make the language consistent with other provisions of this regulation as well as other regulations. First, the phrase "in this state" was added to the first sentence of subsection (c)(1)(A) for clarification that the sale would be assigned to this state if the billing address were in this state. This was done to be consistent with the language of other subsections in this regulation as well as other Revenue and Taxation Code and Regulation sections. Typically, under Revenue and Taxation Code and Regulation sections, in connection with assignment of an item to a state under any of the apportionment factors, assignment will be made "in this state" as opposed to "California" or

any location in general. Second, "by" was replaced with "based on" for consistency with other similar provisions in this regulation. Third, "benefit of the" was added before the word "service" to be consistent with the statutory language. Fourth, "[P]erformed" was replaced by "received" also to be consistent with the statutory language and its market-based intent as well as to make this provision consistent with similar provisions in this regulation. This last change was made pursuant to a comment made at the hearing on this regulation.

(A) The location of the benefit of the service shall be presumed to be received in this state if the billing address of the taxpayer's customer, as determined at the end of the taxable year, is in this state. If the taxpayer uses the customer's billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this assignment. This presumption may be overcome by the taxpayer by showing, ~~by~~ based on a preponderance of the evidence, that either the contract between the taxpayer and the taxpayer's customer, or other books and records of the taxpayer kept in the normal course of business, provide the extent to which the benefit of the service is ~~performed~~ received at a location (or locations) in this state. If the taxpayer believes it has overcome the presumption and uses an alternative method based on either the contract between the taxpayer and the taxpayer's customer or other books and records of the taxpayer kept in the normal course of business, the Franchise Tax Board may examine the taxpayer's alternative method to determine if the billing address presumption has been overcome and, if so, whether the taxpayer's alternate method of assignment reasonably reflects where the benefit of the service was received by the taxpayer's customers.

13. Subsection (c)(1)(B) is the second cascading rule for the assignment of sales of services made to individuals. The first point of this second cascading rule is that the presumption in the first cascading rule, that the billing address is presumed to be the location where the benefit of the services are received, must be overcome prior to application of the second cascading rule, and, in addition, that there are no alternate methods that can be determined by looking at the contract with the customer or the taxpayer's books and records. To make the subsection clearer and consistent with the wording of other similar provisions in this regulation, "yet no" has been deleted and replaced with "and an" so that the sentence reads that if the presumption in the first cascading rule is overcome "and an alternate method cannot be determined..." then assignment shall be reasonably approximated. "Determined" is the preferred term in this context and is consistently used throughout this regulation and so replaces "derived." Finally, throughout this regulation when referring to the "taxpayer's contract with its customer or the taxpayer's books and records", the "taxpayer's contract with its customer" is listed first and the "taxpayer's books and records" is listed second. This subsection is modified to reflect that consistent order.

(B) If the presumption in (c)(1)(A)is overcome by the taxpayer, ~~yet no~~ and an alternative method cannot be ~~derived~~ determined by reference to the contract between the taxpayer and its customer or the taxpayer's books and records ~~of the taxpayer~~ kept in the normal course of business ~~or the contract between the taxpayer and its customer,~~ then the location where the

benefit of the services is received by the customer shall be reasonably approximated.

14. Subsection (c)(1)(C)1 provides an example of the assignment of sales of services to individuals. It has been completely revised to illustrate possible different facts in the case of sales of services within the telecommunications industry which facts would indicate that for some telecommunication taxpayers the billing address would not reflect the market of its consumers, and the market for telecommunications services might be more accurately determined by the net plant method of assigning sales consistent with the Franchise Tax Board's Multistate Audit Technical Manual section 7805. This amendment was requested by a commenter on this regulation.

1. ~~Phone Corp provides telecommunications services to individuals in this state and other states for a monthly fee billed to the customer's address. Gross receipts from these services are assigned to this state if the billing address of the customer is in this state.~~

   Benefit of a Service – Individual, subsection (c)(1)(A). Phone Corp provides interstate communications and wireless services to individuals in this state and other states for a monthly fee. The vast majority of consumers of mobile services receive the benefit of the services at many locations. As a result, a customer's billing address may not be reflective of the location where the benefit of the services is received by the customer. Phone Corp has net plant facilities located in geographical areas where customers utilize its services, based on market size and demand. Phone Corp's books and records, kept in the normal course of the business, identify the net plant facilities used in providing the communications services to Phone Corp's customers. Because Phone Corp's books and records show where the benefit of the services is actually received, the presumption of billing address is overcome. Receipts from interstate communications and wireless services may be attributable to this state based upon the ratio of California net plant facilities over total net plant facilities used to provide those services. Revenues from interstate and international calls may be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call.

15. Subsection(c)(1)(C)2 is another example for assignment of sales of services to individuals. Originally, the second paragraph of this example had not been numbered or lettered. The second paragraph has now been pulled up into the first paragraph, subsection (c)(1)(C)2. This change was made for clarity and consistency with other examples within this regulation.

In addition, the example has been revised in several other ways. First, the phrase "books and" has been inserted in front of the word "records." This term with the inserted words is consistent with other similar provisions throughout this regulation and other Revenue and Taxation Code and Regulation provisions. Second, after the word "records" the phrase "maintained in the regular course of business" was inserted. The phrase "books and records"

usually appears with the modifying phrase "maintained in the regular course of business" when initially referred to in a subsection. This is consistent with other provisions throughout this regulation as well as other Revenue and Taxation Code and Regulation sections. However, when the term "books and records" is mentioned a second time in the same subsection, the modifying term "maintained in the regular course of business" need not appear, as it is generally understood that the books and records are the same books and records identified earlier in the subsection. As a result, the second reference to "maintained in the regular course of business" in this subsection was deleted.

2. Benefit of the Service – Individual, subsection (c)(1)(A). Travel Support Corp located in this state provides travel information services to its customers, who are individuals located throughout the United States, through a call center located in this state. The contract between Travel Support Corp and its customers provides that for a fee per call, the customer can call Travel Support Corp for information regarding hotels, restaurants and other travel related information. Travel Support Corp's books and records maintained in the regular course of business indicate that fifteen (15) percent of its customers have billing addresses in this state. However, Travel Support Corp's books and records~~, maintained in the regular course of business,~~ indicate that only seven (7) percent of the calls handled by the call center originate from this state. Because Travel Support Corp's books and records show where the benefit of the services is actually received, the billing address presumption is overcome and the books and records of the taxpayer may be used to assign seven (7) percent of the gross receipts from the support services provided by the call center to this state.

16. Subsection (c)(1)(C)3 is an example of when a taxpayer may not overcome the presumption that the billing address is the location where the benefit was received. This example was revised to give a reason as to why the presumption was not overcome. After the language "The fact that only seven (7) percent of the calls originate from this state does not overcome the presumption that the benefit of the services is received at the billing address", the statement "This is because the charges are not based on a per call basis but rather a flat monthly fee" was added.

3. Benefit of the Service – Individual, subsection (c)(1)(A). Same facts as Example 2 except the contract between Travel Support Corp and its customers provides for a set monthly fee, regardless of whether the customer actually calls for travel support. This is because the charges are not based on a per call basis but rather a flat monthly fee.

17. Subsection (c)(1)(C)4 was inserted to provide an example as to how the cascading rule of reasonable approximation for sales of services to an individual works. It has been identified as "Benefit of the Service – Individual, subsection (c)(1)(B)." An example of this cascading rule had not been provided in previous drafts. It is the intent of the Department to provide at least one example for every cascading rule to show how each rule works.

4. Benefit of the Service – Individual, subsection (c)(1)(B). Satellite Music Corp has a contract with Car Dealer Corp to provide satellite music service to Car Dealer Corp's retail customers who buy Make and

Model X car. Car Dealer Corp's customers pre-pay for a two (2) year service plan to receive satellite music at a discounted rate as part of the purchase price of the Make and Model X car. While Satellite Music Corp requires an email address for Car Dealer Corp's customers who receive the benefit of this service, Satellite Music Corp does not have access to information as to the billing address or physical location of Car Dealer Corp's customers. Satellite Music Corp may reasonably approximate the location where Car Dealer Corp's customers receive the benefit of its satellite music service by a ratio of the number of Car Dealer Corp locations that offer the two (2) year service plan with Satellite Music Corp to its customers in this state to the number of Car Dealer Corp locations that offer the two (2) year service plan with Satellite Music Corp to its customers located everywhere.

18. Subsections (c)(2) and (c)(2)(A) originally provided the first cascading rule for sales of services to business entities. Now (c)(2) has been revised so that it is a segue to the cascading rules for assignment of sales of services to business entities that appear below it in (A) through (D). This type of format is cleaner and clearer: all cascading rule subsections are contained within the same subsection, i.e. (A) through (D) and not as they were previously set forth in subsection (c)(2), i.e. (2) and (2) (A) through (C). Also, this format is consistent with the provisions for cascading rules in (d), sales of intangible property.

In subsection (c)(2), several changes have been made. First, "receipt of" has been inserted in front of the words "the benefit of the service" to be consistent with the statutory language as well as other provisions of this regulation. Second, "determined as follows:" has been added to indicate this subsection is the segue for the cascading rules to come under subsections (A) through (D) in connection with assignment of sales of services to business entities. Third, the language of the first cascading rule that assignment will be determined by the contract with the customer or the taxpayer's books and records has been deleted.

(2) In the case where a corporation or other business entity is the taxpayer's customer, receipt of the benefit of the service shall be ~~presumed to be received at the location (or locations) indicated by the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records, notwithstanding the billing address of the taxpayer's customer~~ determined as follows:

19. Subsection (c)(2)(A) now contains the first cascading rule of assignment based on the contracts with the customer or the taxpayer's books and records previously set forth in (c)(2). In addition, this rule was modified so that the language is consistent with other provisions in this regulation and other regulations. Hence, the provision starts with "The location of the benefit of the service..." Then, the cascading rule is inserted immediately preceding the original language of subsection (c)(2)(A) on how a taxpayer may overcome the presumption that the contract or the taxpayer's books and records indicates the location where the benefit of the services is received. Lastly, "upon an evidentiary showing" was deleted and inserted after "by" is "showing based on" also to be consistent with other similar provisions of the regulation. Commas were added where appropriate in that same sentence.

(A) ~~To the extent that the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records (notwithstanding the billing address of the taxpayer's customer) kept in the normal course of business provide the location (or locations) where the benefit of the services is received, such location (or locations) will be presumed to be where the benefit of the service is actually received.~~ The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer's customer, indicate the benefit of the service is in this state. This presumption may be overcome by the taxpayer or the Franchise Tax Board ~~upon an evidentiary showing~~ by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.

20. Subsection (c)(2)(C), the third cascading rule for assignment of sales of services to business entities, has been revised to insert the phrases "in this state if" and "is in the state" to be consistent with the language of other subsections in this regulation as well as other Revenue and Taxation Code and Regulation sections. Typically, under the Revenue and Taxation Code and other Regulations, in connection with assignment of an item to a state under any of the apportionment factors, assignment will be made "in this state" as opposed to "California" or any location in general. Insertion of the phrase, "is in this state", at the end of the sentence completes the sentence.

(C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or reasonably approximated under subparagraph (B), then the location where the benefit of the service is received shall be presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state.

21. Subsection (c)(2)(E)3 provides an example for the first cascading rule for sales of services to business entities and provides guidance on how either the contract between the taxpayer and its customer or a taxpayer's books and records can determine the location where the benefit of the services was received by a business entity customer. The word "its" was exchanged for the term "Client Corp's" so that the facts are clearer.

3. Benefit of the Service – Business Entity, subsection (c)(2)(A). Audit Corp is located in this state and provides accounting, attest, consulting, and tax services for Client Corp. The contract between Audit Corp and Client Corp provides that Audit Corp is to audit Client Corp for taxable year ended 20XX. Client Corp's books and records kept in the normal course of business, as well as ~~its~~ Client Corp's internal controls and assets, are located in States A, B and this state. As a result, Audit Corp's staff will perform the audit activities in States A, B and this state. Audit Corp's business books and records track hours worked by location where its employees performed their service. Audit Corp's receipts are attributable to this state and States A and B

according to the taxpayer's books and records which indicate time spent in each state by each staff member.

22. Subsections (c)(2)(E)4 and 5 are examples based on similar facts exhibiting how the books and records cascading rule and the reasonable approximation cascading rule works for sale of services to business entities. Originally, the first paragraph under (c)(2)(E)4 was numbered 4.a and the second paragraph was numbered 4.b. To be consistent with other examples throughout the regulation, the provision "a" was moved up into 4, making 4 and 4.a one example. Then, "b" was renumbered "5" as its own example. Because "5" is now its own example, the language "Same facts as in Example 4 except" was added to the beginning of the example. This format is also consistent with other examples in this regulation. Secondly, since for purposes of this particular example the term "viewers" is more accurate than "subscribers", "subscribers" was substituted for "viewers".

4. Benefit of the Service – Business Entity, subsection (c)(2)(A). Web Corp provides internet content to its viewers and receives revenue from providing advertising services to other businesses. Web Corp's contracts with other businesses do not indicate the location (or locations) where the benefit of the service is received. The advertisements are shown via the website to Web Corp viewers and the fee collected is determined by reference to the number of times the advertisement is viewed and/or clicked on by viewers of the website. ~~a.~~ If Web Corp, through its books and records kept in the normal course of business, can determine the location from which the advertisement is viewed and/or clicked on by viewers of the website, then gross receipts from the advertising will be assigned to this state by a ratio of the number of viewings and/or clicks of the advertisement in this state to the total number of viewings and/or clicks on the advertisement.

~~b.~~5. Benefit of the Service – Business Entity, subsection (c)(2)(B). Same facts as Example 4~~.~~ except ~~If~~ Web Corp cannot determine the location from which the advertisement is viewed and/or clicked on through its books and records, it shall reasonably approximate the location of the receipt of the benefit by assigning its gross receipts from advertising by a ratio of the number of its viewers in this state to the number of its ~~subscribers~~ viewers everywhere.

23. Subsection (c)(2)(E)6 and 7 are examples with the same facts that show how the third and fourth cascading rules for sales of services to business entities work in the event the first cascading rule (the contract between the taxpayer and the customer or the taxpayer's books and records) and the second cascading rule (reasonable approximation) do not provide a method for determining where the location of the receipt of the benefit of the service, i.e. where the customer has received value from delivery of the service (see definition of "Benefit of a service is received" subsection (b)(1).) Several changes have been made to these examples.

First, what used to be subsection (c)(2)(E)6.a has been brought into what is now subsection (c)(2)(E)6, making the subsections of 6 and 6.a one example. What used to be subsection (c)(2)(E)6.b has been renumbered to 7 and made its own example. Because "7" is now its own example, the phrase "Same facts as Example 6" has been added to the beginning of the example. These changes were made for clarity and consistency with the other examples throughout the regulation.

Second, to make it clearer in this example that the first two cascading rules do not provide a method for determining how much value Western Corp received from Painting Corp's painting services delivered in this state, additional critical factors (shape and surface of the buildings to be painted, and materials used) have been added as necessary facts which are missing so that determination of this state's receipt of its pro-rata portion of value of the painting service under the first two cascading rules is not possible. The "number" factor was deleted because that fact would be known since the location of the buildings is known. "At each location" was deleted as unnecessary. These facts were added or deleted based on comments received for this regulation that assignment could be reasonably approximated.

Third, while it is stated in the example that neither the contract between Painting Corp and Western Corp nor Painting Corp's books and records (the first cascading rule) indicate any method for determination of the extent that the benefit of the services was received in this state, the example failed to specifically mention that there is also no method of reasonable approximation (the second cascading rule) of the extent the benefit of the services was received in this state. It is important that it is clearly stated that the first two cascading rules do not determine assignment of the sale because only then does the next cascading rule apply. As a result, the language "In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received" has been added to the example. This language allows application of the third cascading rule (the place from which the order was made), which is the purpose of example of (c)(2)(E)6.

If a taxpayer cannot assign the sale to the place from which the order was made (the third cascading rule) then it is assigned to the customer's billing address (the fourth cascading rule) which is the purpose of the example (c)(2)(E)7. The example has been modified to state "subsection (c)(2)(C)" instead of "subparagraph a" to reflect how it is currently numbered.

6. Benefit of the Service – Business Entity, subsection (c)(2)(C). For a flat fee, Painting Corp ~~a~~ contracts with Western Corp to paint Western Corp's various sized, shaped and surfaced buildings located in this state and four (4) other states. The contract does not break down the cost of the painting per building or per state. Painting Corp's books and records kept in the normal course of business indicate the location of the buildings that are to be painted but do not provide any method for determining or reasonably approximating the extent that the benefit of the service is received in this state, i.e. the size, shape, or ~~number~~ surface of each building~~s~~, or the materials used for each building~~s~~ to be painted ~~at each location~~. In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received. ~~a.~~ Since neither the contract nor Painting Corp's

books and records indicate how much of the fee is attributable to this state and there is no method of reasonably approximating the location of where the benefit of the service is received, the sale will be assigned to this state if the order for the service was placed from this state.

~~b.~~7~~.~~ Benefit of the Service – Business Entity, subsection (c)(2)(D). Same facts as Example 6~~.~~ ~~If~~ except the sale cannot be assigned under ~~subparagraph a.~~ subsection (c)(2)(C), then the sale shall be assigned to this state if Western Corp's billing address is in this state.

24. Subsection (d)(1), the segue for the first cascading rule for sales of intangible property where there has been a complete transfer of all property rights, has been revised to be consistent with the underlying statute, which provides that assignment of sales of intangibles shall be based on the location of the use of the intangible property. As a result, the phrase "location of the use of the" has been inserted before "the intangible property" for purposes of being consistent with the underlying statute. Consequently, the phrase "in this state" has been deleted as unnecessary as it appears in the cascading rules below. This is consistent with other provisions in this regulation.

(1) In the case of the complete transfer of all property rights in intangible property as defined in subsection (b)(~~5~~3), for a jurisdiction or jurisdictions, the location of the use of the intangible property ~~in this state~~ shall be determined as follows:

25. Subsection (d)(1)(A), the first cascading rule for sales of intangible property where there has been a complete transfer of all property rights, has been modified.

First, the phrase "location of the use of the intangible property shall be presumed to be in this state to the extent the" was added to the beginning of the subsection to be consistent with the wording of similar presumptive language in the provisions for assignment of sales of services in subsection (c). Further down in the same sentence, the phrase "shall be presumed to provide where the purchaser will use the intangible at the time of the purchase" was deleted accordingly. Also in the first sentence, the word "indicate" replaces the word "provide" to be consistent with the wording of the provisions for assignment of sales of services in subsection (c). For clarity, the phrase "that the intangible property is used" was inserted before "in this state", and "at the time of sale" was added to the end of the sentence.

In the second sentence, the two words "books and" were added before the word "records" to complete the phrase as it is generally known and so that the term is consistently worded throughout this regulation. Also, "for the most recent twelve (12) month taxable year" was added in order to identify the time period for determining the extent of the use of the intangible property in this state by the taxpayer prior to the sale.

In the third sentence, to be consistent in the wording with other similar provisions in this regulation, the phrase "showing based on" was added prior to the phrase, "preponderance of the evidence" and "showing" was deleted immediately after "preponderance of the evidence."

In the final sentence, for clarity, the term "actual location of the use" was put in place of "purchaser's use" and the phrase "property by the purchaser" was added after the word "intangible" so it now reads "the actual location of the use of the intangible property by the purchaser..." The term "intangible property" was originally referred to here as only "intangible", hence the word "property" was added to "intangible" to complete the term as it is generally known. Commas have been added where appropriate. As a result of rephrasing this sentence, "showing" and "purchaser's use" were deleted.

(A) The location of the use of the intangible property shall be presumed to be in this state to the extent that the contract between the taxpayer and the purchaser, or the taxpayer's books and records kept in the normal course of business~~, shall be presumed to~~ indicate ~~provide where the purchaser will use the intangible at the time of purchase~~ that the intangible property is used ~~it is~~ in this state at the time of the sale. This may include books and records providing the extent that the intangible property is used in this state by the taxpayer for the most recent twelve (12) month taxable year prior to the time of the sale of the intangible property. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, ~~showing~~ that the actual location of the use ~~purchaser's use~~ of the intangible property by the purchaser at the time of purchase is not consistent with the terms of the contract or the taxpayer's books and records.

26. Subsections (d)(1)(A)1, (d)(1)(A)1.a and (d)(1)(A)1.b are assignment rules for sales of intangible property in the event of a sale of an interest in a corporation or a pass-through entity. Subsection (d)(1)(A)1.a was originally set out as an example for the sale of stock (see subsection (d)(1)(D)(1), strikeout version.)

At the hearing for this regulation, comments were received that (1) it is better tax policy to set forth the law in statutory or regulatory provisions instead of by example, (2) sales of interests in pass-through entities should be included, (3) a separate provision should be created for sales of interests where the underlying assets consist of more than 50% intangible property whereby assignment of the sale of the interest should be based on the principles in Revenue and Taxation Code section 25125, subdivision (d), and (4) in calculating the assignment of the sale, the average of the factors referred to in subsection (d)(1)(A)1.a and the sales factor referred to in subsection (d)(1)(A)1.b should be determined by the most recent 12-month taxable year prior to the time of the sale. As a result of these comments, assignment mechanism rules for a sale of stock in a corporation or an ownership interest in a pass-through entity were created in subsections (d)(1)(A)1.a and (d)(1)(A)1.b.

Subsection (d)(1)(A)1 was created as a segue for the rules set forth in (d)(1)(A)1.a and (d)(1)(A)1.b. This is consistent with the provisions in subsection (c).

Subsection (d)(1)(A)1.a reflects the principles of the example originally set out in (d)(1)(D)1 and incorporates the comments received. That subsection states that in the event of a sale of stock in a corporation or an ownership interest in a pass-through entity where 50% or more of the amount of the assets of the corporation or pass-through entity, determined

using the original cost basis, consist of real and/or tangible personal property, the sale will be assigned by averaging the California payroll and property factors of the entity sold. The average of the factors will be determined by the most recent 12-month taxable year prior to the time of sale according to the taxpayer's books and records. It is felt that the payroll and property factors reflect the value and location of where the intangible property, the underlying assets of the entity sold, was employed (see definition of "the use of the intangible property," subsection (b)(6)) at the time of the sale and therefore is an appropriate way to assign the sale of intangible property where 50% or more of the underlying assets consist of real and/or tangible personal property.

Subsection (d)(1)(A)1.b was created to provide for assignment of a sale of stock in a corporation or an ownership interest in a pass-through entity where more than 50% of the amount of the corporation's or pass-through entity's underlying assets, determined by using the original cost basis, consist of intangible property. This subsection states that the sale will be assigned by using the California sales factor of the entity sold for the most recent 12-month tax period prior to the time of sale according to the taxpayer's books and records. This entire subsection is based on comments received at the hearing. Here, the sales factor reflects the value and location of where the intangible property, such as goodwill, was employed (see definition of "the use of intangible property," subsection (b)(6)) at the time of sale, and, as a result, is an appropriate way to determine assignment of sale of stock or ownership interest where the majority of the underlying assets consist of intangible property.

1. Where the sale of intangible property is the sale of stock in a corporation or the sale of an ownership interest in a pass-through entity the following rules apply:

a. In the event that fifty (50) % or more of the amount of the assets of the corporation or pass-through entity sold, determined using the original cost basis of those assets, consist of real and/or tangible personal property, the sale of the stock or ownership interest will be assigned by averaging the payroll and property factors of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records kept in the normal course of business.

b. In the event that more than fifty (50) % of the amount of the assets of the corporation or pass-through entity sold, determined using the original costs basis of those assets, consist of intangible property, the sale of the stock or ownership interest will be assigned by using the sales factor of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records.

27. Subsection (d)(1)(B), the second cascading rule of reasonable approximation for sales of intangible property where there has been a complete transfer of all property rights, has been modified to delete the conditions and limitations for reasonable approximation because those conditions and limitations have been moved to the general definition of reasonable approximation at subsection (b)(4), thereby making them applicable to all provisions in this regulation.

(B) If the extent of the use of the intangible property in this state cannot be determined under subparagraph (A) or the presumption under subparagraph (A) is overcome, the location where the intangible property is used shall be reasonably approximated. ~~by reference to the activities of the purchaser, limited to the jurisdictions where the purchaser, at the time of purchase, will use the intangible, to the extent such information is available to the taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population, unless it can be shown by the taxpayer that the intangible is being used materially in other parts of the world. If this is shown then only the populations of those other countries where the intangible is being materially used shall be added to the U.S. population~~.

28. Subsection (d)(1)(C) is the third cascading rule. This rule provides that if the taxpayer cannot apply the rules in (d)(1)(A) or (d)(1)(B), that the location of the customer's billing address will be used to assign sales of intangible property where there has been a complete transfer of all property rights. This rule has been modified to reflect the standard assignment language found in other sections of the Revenue and Taxation Code and Regulations. Typically, assignment will be made "to this state" as opposed to "California" or any location in general. As a result, the words "this state if" were inserted after the phrase "the gross receipts shall be assigned to". Secondly, after the phrase "the billing address of the purchaser" the phrase "is in this state" was added.

(C) If the extent of the use of the intangible property in this state cannot be determined pursuant to subparagraphs (A) or (B), then the gross receipts shall be assigned to <u>this state if</u> the billing address of the purchaser <u>is in this state.</u>

29. Subsection (d)(1)(D)1 is an example showing the application of the cascading rule for assigning a sale of an interest in a corporation or pass-through entity where 50% or more of the amount of the underlying assets, determined by using the original cost basis, are real or tangible personal property. Language was added to indicate that this example addresses the provision where the underlying assets of the corporation or entity sold consist of predominantly tangible personal property. "[A]t the time of sale" was moved to the beginning of the sentence to address both the new language and the first sentence. The phrase, "in its most recent 12-month taxable year preceding the sale", has been inserted to define the time period that the payroll and property factors are to be averaged for determining assignment of the sale of stock.

~~(1)~~ <u>1. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.a.</u> Parent Corp sells all of the of stock of Subsidiary Corp. <u>At</u>

the time of sale, the predominant value of Subsidiary Corp's assets consists of tangible personal property and~~.~~ Subsidiary Corp~~, at the time of sale,~~ had locations in this state and three (3) other states. Taxpayer's books and records indicate Subsidiary Corp had payroll and property in this state of 15% and 25%, respectively, in its twelve (12) month taxable year preceding the sale. In assigning the receipt from the sale of Subsidiary Corp. Taxpayer may average the property and payroll percentages and assign 20% of the receipt from the sale to this state.

30. Subsection (d)(1)(D)2 has been inserted as an example of the cascading rule in subsection (d)(1)(A)1.b of assigning the sale of stock of a corporation or an interest in a pass-through entity where more than 50% of the amount of the underlying assets, determined by using the original cost basis, is intangible property.

~~(2)~~ 2. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.a. Parent Corp sells an interest in Target Entity. At the time of the sale, the predominant value (over 50%) of Target Entity's assets consists of intangible property. Target Entity's books and records indicate that 30% of Target Entity's sales were assigned to California during the most recent full tax period preceding the sale. Parent Corp may assign 30% of the receipt from the sale of the interest in Target Entity to this state.

31. Subsection (d)(1)(D)3 is an example of the second cascading rule of reasonable approximation for assigning sales of intangible property where a complete transfer of all property rights has been made. This example has been clarified by renaming the corporations by what they do. This is consistent with all other examples in this regulation. As a result, "Taxpayer" has been replaced with "R&D Corp", and "Buyer" has been replaced with "Manu." Also, because this example is intended to show how a taxpayer may reasonably approximate the location of the use of the intangible property, the words "may reasonably approximate the location of the use by assigning" have been inserted in place of the word, "assigns" for clarity.

~~(3)~~3. Intangible Property – Complete Transfer, subsection (d)(1)(B). ~~Taxpayer~~ R&D Corp sells a patent to ~~Buyer~~ Manu Corp that will be used by ~~Buyer~~ Manu Corp to manufacture products for sale in the United States. The contract between ~~Taxpayer~~ R&D Corp and ~~Buyer~~ Manu Corp indicates that ~~Buyer~~ Manu Corp will have the exclusive rights to the patent for exploitation in the United States. At the time of the purchase, ~~Taxpayer~~ R&D Corp knows that ~~Buyer~~ Manu Corp has three factories that will use the patented process in manufacturing, one of which is located in this state. In the absence of specific information as to the amount of manufacturing ~~Buyer~~ Manu Corp does at each of the three locations, ~~Taxpayer~~ R&D Corp may reasonably approximate the location of the use by assigning ~~assigns~~ the receipts from the sale equally among the three states where ~~Buyer~~ Manu Corp has manufacturing plants, assigning 33% of the sale to this state.

32. Subsection (d)(1)(D)4 is an example of the third cascading rule. This rule provides that the customer's billing address shall be used for assigning sales of intangible property in the case of a complete transfer of all property rights. This example has been clarified by renaming the corporations by what they do. This is consistent with all other examples in this regulation. As a result, "Taxpayer" has been replaced with "R&D Corp" and "Buyer" has been replaced with "Manu." Also, the word "facts" has been added for clarity. "[S]hall" replaces "may" and "except" replaces "but" to be consistent with other similar provisions in this regulation.

> ~~(1)~~ 4. Intangible Property – Complete Transfer, subsection (d)(1)(C). Same facts as Example ~~(3)~~, ~~but~~ ~~Taxpayer~~ except R&D Corp has no information regarding ~~Buyer~~ Manu Corp's activities. ~~Taxpayer~~ R&D Corp ~~may~~ shall assign the receipt to the billing address of ~~Buyer~~ Manu Corp.

33. Subsection (d)(2)(A)1 is the provision for assignment of sales where the intangible property sold is a "marketing intangible." A commenter for this regulation suggested that the language was duplicative, and, therefore by implication, also unclear. As a result of the comment, changes have been made to clearly articulate the 3 prongs of this marketing intangible provision. The three prongs are: (1) sales are assigned to this state to the extent the ultimate customer of the goods or services to which licensing fees are attributed is in this state, (2) the contract between the taxpayer and licensee or the taxpayer's books and records are presumed to indicate the method for determination of the ultimate customer in this state, and (3) the presumption of the contract or books and records may be overcome based on a preponderance of the evidence.

In connection with the first prong (sales are assigned based on location of ultimate customer), there have been several changes made for clarity. First, the subsection originally contained one long sentence which included the provisions for both the first prong and the second prong. Now, the two prongs have been divided into two separate sentences. The first prong is the first sentence of this subsection and provides the general rule for assignment of sales for marketing intangibles. The second prong is the second sentence and provides the presumptive first cascading rule on how to assign such sales (discussed infra). In the first sentence, the word "ultimate" was added preceding "customer" to make it clear that it is the ultimate customer that determines the location of assignment of the sale. Also, the phrase "presumed to be" was deleted as unnecessary because the first cascading rule (contract or books and records are presumed to indicate the method of location of the ultimate customer) to which the presumption was intended to attach is now in the second sentence.

In connection with the second prong (the contract or books and records are presumed to indicate the method of location of the ultimate customer), the presumption language itself has been rephrased so that it is clearer and consistent with other similar provisions in this regulation. In addition, based on comments received, language clearly stating that the contract or books and records "are presumed" to provide a method for determination of the location of the ultimate customers has been inserted. Also, as in the previous sentence, the word "ultimate" is inserted before "customers" for purposes of clarity. This prong is represented in the second sentence of this subsection.

In connection with the third prong (overcoming the presumption), previously there was no language as to how the presumption could be overcome (thereby allowing application of the second cascading rule of reasonable approximation which appears in the following subsection). Language as to how to overcome the presumption was added as the third sentence to this subsection. It is consistent with other similar provisions in this regulation.

1. Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items, the royalties or other licensing fees paid by the licensee for such right(s) ~~are presumed to be~~ attributable to this state to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by ~~this states~~ ultimate customers in this state.~~, as is provided for by the terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business. If~~ The contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to provide a method for determination of ~~this state's~~ the ultimate customers in this state for the purchase of goods, services, or other items in connection with the use of the intangible property~~, then the contract's terms or the taxpayer's books and records shall be used to determine this state's customers for the purchase of goods, services, or other items in connection with the use of the intangible property~~. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing based on a preponderance of the evidence that the ultimate customers in this state are not determinable under the contract or the taxpayer's books and records.

34. Subsections(d)(2)(A)2 provides the second cascading rule for assignment of "marketing intangibles" which states that if assignment cannot be made under the previous provision, then assignment shall be done by reasonable approximation. This subsection was reworded to be consistent with other similar provisions in the regulation, including the addition that if the presumption in the preceding paragraph is overcome, then the location of the use of the intangible property shall be reasonably approximated. This subsection has been modified to delete the conditions and limitations of reasonable approximation because those conditions and limitations have been inserted into the general definition of reasonable approximation in subsection (b)(4), thereby making them applicable to all provisions in this regulation.

Finally, the last sentence provides factors to consider in determining the customer's or licensee's use of "marketing intangibles." This provision was originally located under "Special Rules" in subsection (g)(2) and applicable to the regulation as a whole. However, the rule is specific to assignment of sales of "marketing intangibles" and therefore was relocated to the provision for the first cascading rule for assignment of "marketing intangibles." The phrase "including population" was deleted as unnecessary. For clarity, other changes were made and include replacing "intangible property" with "marketing intangibles" and deleting "for use of marketing intangibles".

2. If the location of the use of the intangible property is not determinable under subparagraph 1 or the presumption under subparagraph 1 is overcome, the location of the use of the intangible property shall be reasonably approximated. ~~by reference to the activities of the taxpayer's licensee customer to the extent such information is available to the taxpayer. Reasonable approximation of the location of the use of the intangible property includes, but is not limited to, the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items, to the extent such information is available to the taxpayer.~~ To determine the customer's or licensee's use of ~~intangible property~~ marketing intangibles in this state ~~under subsection (d)(2)(A)2 for use of marketing intangibles~~, factors that may be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state, or other data ~~including population~~ that reflects the relative usage of the intangible property in this state.

35. Subsection (d)(2)(A)3 is a population assignment provision specific for marketing intangibles sold at the wholesale level. The assignment language was modified to be consistent with the language for the use of population as a method of assignment in the definition of reasonable approximation in subsection (b)(4).

3. Where the license of a marketing intangible property is for the right to use the intangible property in connection with sales or other transfers at wholesale rather than directly to retail customers, the taxpayer may be unable to develop information regarding the location of the ultimate use of the intangible property. If this is the case, then the taxpayer may attribute the receipt to this state based solely upon the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items. ~~Only the populations of those countries where the intangible is being materially used shall be taken into account.~~ The population used shall be the U.S. population, unless it can be shown by the taxpayer that the intangible property is being used materially in other parts of the world. If this is shown then only the populations of those other countries where the intangible is being materially used shall be added to the U.S. population.

36. Subsection (d)(2)(B)1 is the first cascading rule regarding non-marketing or manufacturing intangibles. For consistency purposes, the provision was changed to mirror the first cascading rule of marketing intangibles in subsection (d)(2)(A)1. Thus, the first sentence provides the general rule for assignment of non-marketing/manufacturing sales, and the second sentence contains the presumptive first cascading rule on how to assign such sales. The third sentence is now consistent with marketing intangibles and other similar provisions in the regulation and provides language on overcoming a presumption. Thus, "by a preponderance of the evidence" was deleted and "by showing, based on a preponderance of the evidence, that the extent of the use for which the fees are paid are

not determinable under the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records" was inserted in its place.

(B) Non-marketing and manufacturing intangibles.

1. Where a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, the licensing fees paid by the licensee for such right(s) are ~~presumed to be~~ attributable to this state to the extent that the use for which the fees are paid takes place in this state~~, as is provided for by~~. ~~t~~The terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to~~. If the contract or the taxpayer's books and records~~ provide a method for determination of the extent of the use of the intangible property in this state~~, then the contract's terms or the taxpayer's books and records will be presumed to properly indicate the extent of the use of the intangible property in this state~~. This presumption may be overcome ~~by~~ ~~a preponderance of the evidence~~ by the taxpayer or the Franchise Tax Board by showing, based on preponderance of evidence, that the extent of the use for which the fees are paid are not determinable under the contract or the taxpayer's books and records.

37. Subsection (d)(2)(B)2 provides the second cascading rule for the assignment of sales of non-marketing and manufacturing intangibles. The phrase "for which the fees are paid" was deleted as unnecessary and inconsistent with the language of similar provisions in the regulation. Finally, this subsection has been modified to delete the conditions and limitations of reasonable approximation because those conditions and limitations have been moved to the general definition of reasonable approximations at subsection (b)(4), making them applicable to all provisions of this regulation.

2. If the location of the use of the intangible property ~~for which the fees are paid~~ cannot be determined under subparagraph 1 or the presumption in subparagraph 1 is overcome, then the location of the use of the intangible property shall be reasonably approximated. ~~by reference to the activities of the taxpayer's customer, to the extent such information is available to the taxpayer.~~

38. Subsection (d)(2)(C)1 is the first cascading rule for assignment of sales of mixed intangibles. For clarity, the single word "Where" was replaced with the phrase "Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing or manufacturing intangible and..." in the last sentence "or manufacturing" was added to "non-marketing" to complete the term, mixed intangibles, as it is defined in subsection (b)(3)(C).

(C) Mixed intangibles.

1. Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing or manufacturing intangible and the fees to be paid in each instance are separately stated in the licensing contract, the Franchise Tax Board will accept such separate statement for purposes of this section if it is reasonable. If the Franchise Tax Board determines that the separate statement is not reasonable, then the Franchise Tax Board may assign the fees using a reasonable method that accurately reflects the licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible.

39. Subsection (d)(2)(C)2 is the second cascading rule for assignment of sales of mixed intangibles. The phrase "a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible" is unnecessary as the definitional language of a mixed intangible already appears immediately above in subsection (d)(2)(C)1. Since this second rule immediately follows the first rule, it is unnecessary to define the term again. Finally, the language on how to overcome the presumption has been added to the end of this provision. This is consistent with other similar subsections of this regulation.

2. Where ~~a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible and~~ the fees to be paid in each instance are not separately stated in the contract, it shall be presumed that the licensing fees are paid entirely for the license of a marketing intangible except to the extent that the taxpayer or the Franchise Tax Board can reasonably establish otherwise. This presumption may be overcome, by a preponderance of the evidence, by the taxpayer or the Franchise Tax Board, that the licensing fees are paid for both the licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible, and the extent to which the fees represent the marketing intangible and the non-marketing or manufacturing intangible.

40. Subsection (d)(2)(D)2 is an example for reasonable approximation for assigning sales of marketing intangibles." "Sports" replaces "Whole" to give the corporation in the example a clearer identity so that the example is easier to understand. In addition, to make it clear that the taxpayer could not determine assignment based on the first cascading rule (the contract or the taxpayer's books and records), language is inserted to state that fact: "Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks." Finally, to make it clear that this is a reasonable approximation example, the word "determined" is replaced with the term "reasonably approximated."

2. Intangible Property – Marketing Intangible, subsection (d)(2)(A)1. ~~Marketing intangible~~. Moniker Corp enters into a license agreement with ~~Whole~~ Sports Corp where ~~Whole~~ Sports Corp is granted the right to use trademarks owned by Moniker Corp to brand sports equipment

that is to be manufactured by ~~Whole~~ Sports Corp or an unrelated entity, and to sell the manufactured product to unrelated companies that make retail sales in a specified geographic region. Although the trademarks in question will be affixed to the tangible property to be manufactured, the license agreement confers a license of a marketing intangible. Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks. The component of the licensing fee that constitutes sales of Moniker Corp in this state is ~~determined~~ reasonably approximated by multiplying the amount of the fee by the percentage of this state's population over the total population in the specified geographic region in which the retail sales are made.

41. Subsection (d)(2)(D)3 is an example for the assignment of sales of a marketing intangible where the sale is to a wholesaler. The previous draft did not contain a wholesale example. As stated above, it is the intent to provide an example to show how each rule in this regulation works.

3. Intangible Property - Marketing Intangible, Wholesale, subsection (d)(2)(A)3. Cartoon Corp enters into a license agreement with Wholesale Corp where Wholesale Corp is granted the right to use Cartoon Corp's cartoon characters in the design and manufacture of tee shirts and sweatshirts which will be sold to various retailers who will in turn sell them to members of the public. Cartoon Corp is unable to develop information regarding the location of the ultimate customer of the products designed and manufactured in connection with Cartoon Corp's cartoon characters. Cartoon Corp shall assign the licensing fee by multiplying the fee by the percentage of this state's population over the total population in the geographic area in which Cartoon Corp markets its goods, services or other items.

42. Subsection (d)(2)(D)5 is an example of the second cascading rule of reasonable approximation for assignment of a sale of a non-marketing or manufacturing intangible property. The previous draft did not contain an example for reasonable approximation in connection with assignment of the sale of non-marketing or manufacturing intangibles, and as stated above, it is the intent to provide an example to show how each rule in this regulation works.

5. Intangible Property - Non-marketing or Manufacturing Intangible, subsection (d)(2)(B)2. Mechanical Corp enters into a license agreement with Spa Corp where Spa Corp is granted the right to use the patents owned by Mechanical Corp to manufacture mechanically operated spa covers for spas that Spa Corp manufactures. Neither the terms of the contract nor the taxpayer's books and records indicate the extent of the use of the patent in this state. However, there is public information that Spa Corp has 3 manufacturing locations in this state and an additional 6 manufacturing locations in various other states.

Mechanical Corp may reasonably approximate the location of the use of the intangible property and assign 33% of the licensing fees to this state.

43. Subsection (d)(2)(D)6 is an example of the third cascading rule of the customer's billing address for assignment of a sale of a non-marketing or manufacturing intangible. The previous draft did not contain an example for customer's billing address, and as stated above, it is the intent to provide an example to show how each rule in this regulation works.

6. Intangible Property - Non-marketing and Manufacturing Intangible, subsection (d)(2)(B)3. Same facts as Example 5 except that Spa Corp is a small, privately held manufacturing corporation that has no publicly available information as to its manufacturing locations, Mechanical Corp shall assign all of the licensing fees to this state if Spa Corp's billing address is in this state.

44. Subsections (d)(2)(D)7 and 8 provide examples of how the two cascading rules for mixed intangibles work. Inadvertently, the facts of the two examples originally appeared in reverse order for application of the cascading rules. The examples' facts have been modified so that they appear in the same order as the cascading rules for mixed intangibles. Thus subsection (d)(2)(D)7's facts refer to where there is a separate and reasonable statement of fees and how the sale would be assigned under those facts, and subsection (d)(2)(D)8's facts refer to where there is no separate statement of fees and how the sale would be assignment under those facts.

~~4~~7. Intangible Property – Mixed Intangible, subsection (d)(2)(C)1. ~~Mixed intangible~~. Axel Corp enters into a two-year license agreement with Biker Corp in which Biker Corp is granted the right to produce motor scooters using patented technology owned by Axel Corp, and also to sell such scooters by marketing the fact that the scooters were manufactured using the special technology. The scooters are manufactured outside this state, but the taxpayer is granted the right to sell the scooters in a geographic area in which this state's population constitutes 25% of the total population in the geographic area during the period in question. The license agreement specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non-marketing intangible. Assuming that the separately stated fees are reasonable, the Franchise Tax Board will: (1) attribute no part of the licensing fee paid for the non-marketing intangible to this state, and (2) attribute 25% of the licensing fee paid for the marketing intangible, to this state. ~~The licensing agreement requires an upfront licensing fee to be paid by Biker Corp to Axel Corp but does not specify which percentage of the fee is derived from Biker Corp's right to use Axel Corp's patented technology. Unless either the taxpayer or the Franchise Tax Board~~

~~reasonably establishes otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible. In such cases, it will be presumed that 25% of the licensing fee constitutes sales in this state.~~

~~5~~8. Intangible Property – Mixed Intangible, subsection (d)(2)(C)2. ~~Mixed intangible.~~ Same facts as Example ~~4~~7, except that ~~the license agreement specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non marketing intangible. Assuming that the separately stated fees are reasonable, the Franchise Tax Board will: (1) attribute no part of the licensing fee paid for the non marketing intangible to this state, and (2) attribute 25% of the licensing fee paid for the marketing intangible to this state. T~~the licensing agreement requires an upfront licensing fee to be paid by Biker Corp to Axel Corp but does not specify which percentage of the fee is derived from Biker Corp's right to use Axel Corp's patented technology. Unless either the taxpayer or the Franchise Tax Board reasonably establishes otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible. In such cases, it will be presumed that 25% of the licensing fee constitutes sales in this state.

45. Subsection (g)(1) provides that the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information to comply with these regulations. The reference is to "assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136." It should reference Revenue and Taxation Code section 25136, subdivision (b), which is the underlying statutory provision for the market-based rules of assigning sales other than sales of tangible personal property. This change has been made.

(1) In assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136(b), the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information, as well as the resources of the taxpayer seeking to obtain this information, and may accept a reasonable approximation when appropriate, such as when the necessary data of a smaller business cannot be reasonably developed from financial records maintained in the regular course of business.

46. Subsection (g)(1)(A) is an example under "Special Rules" to indicate facts when a taxpayer would not be required to alter its recordkeeping method to comply with the provisions of this regulation. A comment at the hearing for this regulation was made that the example gave the impression that only a small corporation would be able to qualify within this provision. As a result, the name of the corporation in the example has been changed to "Misc".

(A) Example. ~~Small~~ Misc Corp, a corporation located in this state, provides limited bookkeeping services to clients both within and outside this state. Some clients have several operations among various states. For the past ten (10) years, ~~Small~~ Misc Corp's only records for the sales of these services have consisted of invoices with the billing address for the client. ~~Small~~ Misc Corp's records have been consistently maintained in this manner. If the FTB determines that ~~Small~~ Misc Corp cannot determine, pursuant to financial records maintained in the regular course of its business, the location where the benefit of the services it performs are received under the rules in this regulation, then ~~Small~~ Misc Corp's sales of services will be assigned to this state using the billing address information maintained by the taxpayer. ~~Small~~ Misc Corp will not be required to alter its recordkeeping method for purposes of this regulation.

47. Subsection (g)(2) lists factors for determination of the location of the use of marketing intangibles. This was moved to the provisions regarding marketing intangibles as subsection (d)(2)(A)2.a. It was determined that this was not a general rule that applied to the entire regulation.

(~~2~~) ~~To determine the customer's or licensee's use of intangible property in this state under subsection (d)(2)(A)2. for use of marketing intangibles, factors that may be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state, or other data including population that reflects the relative usage of the intangible property in this state.~~

48. Subsection (g)(2) is now segue to special rules for reasonable approximation of the location for receipt of the benefit of the services or the location of the use of the intangible property. "[T]he receipt of" was inserted to match the language of the underlying statute and other provisions of this regulation.

(~~3~~2) The following special rules shall apply in determining the method of reasonable approximation of the location for the receipt of the benefit of the services or the location of the use of the intangible property:

49. Subsection (g)(2)(A) provides that once a reasonable approximation method is used, the taxpayer must continue to use that method unless the Franchise Tax Board gives permission for a change to the method. To match the language of the underlying statute and remain consistent with other provisions of this regulation, "receipt of the" was inserted before "benefit of the services." In addition, it has been determined that in fairness to taxpayers, once the Franchise Tax Board has examined the taxpayer's reasonable approximation method and accepted it, the Franchise Tax Board will continue to accept that method until facts and circumstances change such that the method no longer reasonably reflects the market. This is consistent with other provisions of the Revenue and Taxation Code and other Regulations. As a result, language to that effect has been added to this provision.

(A) Once a taxpayer has used a reasonable approximation method to determine the location of the market for the receipt of the benefit of the services or the

location of the use of the intangible property, then the taxpayer must continue to use that method in subsequent taxable years. A change to a different method of reasonable approximation may not be made without the permission of the Franchise Tax Board. Where the Franchise Tax Board has examined the reasonable approximation method and accepted it in writing, the Franchise Tax Board will continue to accept that method, absent any change of material fact such that the method no longer reasonably reflects the market for the receipt of the benefit of the services or the location of the use of the intangible property.

50. Subsection (g)(3)(A) refers to Revenue and Taxation Code section 25136 and Regulation section 25136. "RTC" is changed to "Revenue and Taxation Code". "CCR" is changed to "Regulation" to be consistent with other provisions of this regulation and other regulations. Also, to reflect that the reference is to the market-based rules, it now reads, where appropriate, "Revenue and Taxation Code section 25136, subdivision (a), and Regulation section 25136-2."

(A) All references to ~~RTC~~ Revenue and Taxation Code section and ~~CCR~~ Regulation section 25136 shall refer to ~~RTC~~ Revenue and Taxation Code section 25136(b) and ~~CCR~~ Regulation section 25136-2 as they are operative beginning on and after January 1, 2011.

51. Subsection (g)(3)(C) refers to the incorporation of special industry rules for Franchisors. A comment on this regulation was received that, based on the wording of the subsection, there might be confusion as to whether or not throwout rules apply. To avoid any confusion that throwback or throwout rules apply, language has been inserted indicating that the taxability of a taxpayer in a state is not relevant under the market-based rules. Neither throwback nor throwout rules apply under these market-based rules.

(C) The provisions in Regulation section 25137-3 [Franchisors] that relate to the taxpayer being, or not being, taxable in a state shall not be applicable.

52. Subsection (g)(3)(F) relates to the incorporation of special industry rules for mutual fund providers and specifically refers to assignment of receipts to the location of income-producing activity in the event the taxpayer is not taxable in a state. Those provisions are not applicable to the market-based rules of this regulation and the underlying statute. There is no statutory authority for assignment of a receipt to the location of the income-producing activity if it is not the market state. Therefore, the taxability of a taxpayer in a state which triggers the assignment to the location of the income-producing activity is immaterial and should be eliminated to avoid confusion. At the hearing for this regulation, there was a comment made on that basis.

(F) The provisions in Regulation section 25137-14 that relate to the taxpayer not being taxable in a state and assign the receipts to the location of the income-producing activity that gave rise to the receipts shall not be applicable.

These sufficiently related changes are being made available to the public for the 15 day period required by Government Code section 11346.8, subdivision (c), and California Code of Regulations, title 1, section 44. Written comments regarding these changes will be accepted until 5:00 p.m. on October 24, 2011. The Franchise Tax Board is sending a copy of the proposed amendments to Regulation section 25136 to all individuals who requested notification of such changes, as well as those who commented in writing to the previously noticed proposed amendments to Regulation section 25136.

All inquiries and written comments concerning this notice should be directed to Colleen Berwick at 916-845-3306, FAX 916-845-3648, E-Mail colleen.berwick@ftb.ca.gov; or by mail to the Legal Division, Attn: Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. The notice and the proposed amendments will also be made available at the Franchise Tax Board's website at http://www.ftb.ca.gov/.

TITLE 18. FRANCHISE TAX BOARD
AMENDMENTS TO PROPOSED
REGULATION SECTION 25136, RELATING TO
SALES OF OTHER THAN TANGIBLE PERSONAL PROPERTY

A hearing was held on August 10, 2011, by Melissa Potter of the Franchise Tax Board Legal Division, the "hearing officer," on proposed amendments to California Code of Regulations, title 18, section 25136 (Regulation section 25136), which was noticed in the California Regulatory Notice Register on June 17, 2011.

Department staff reviewed the proposed regulation language and considered the comments submitted at and before the hearing. The hearing officer recommends that the proposed new regulation section number be renumbered for clarity to 25136-2. The hearing officer also recommends that (1) a definition be deleted as unnecessary and another definition be expanded to include limitations that appear in various subsections; (2) examples be added or changed to indicate how all cascading rules operate; (3) examples that follow the cascading rules be identified by the subsection to which they apply; (4) language be added or altered to clarify the provision or to maintain consistency in phraseology throughout this regulation and/or other California regulations; and (5) a provision be added to address how to assign the receipt where there has been a sale of an interest in a corporation or pass-through entity.

These nonsubstantial or sufficiently related changes (within the meaning of Govt. Code Section 11346.8) recommended by the hearing officer are reflected in the attachment hereto. These amendments to the regulation are reflected by underscore for additions and strikeout for deletions. Proposed changes to Regulation section 25136 are summarized below.

1. In a number of places, either a provision has been deleted in its entirety or new one has been inserted. For example, the definition of commercial domicile has been deleted (formally subsection (b)(4)). As a result, the numbering and/or lettering of the regulation subsections have changed in some cases. This is indicated by strikeout or underscore of the number or letter being removed and/or being added. The subsections referred to in these paragraphs refer to the newly assigned number or letter as assigned by this 15 day notice's proposed changes.

2. Many examples have been modified to identify the subsection to which they specifically relate, for instance "Benefit of a Service – Individuals, subsection (c)(1)(A)." This has been done for clarity purposes, in particular where there are examples that appear back-to-back to illustrate an entire set of cascading rules for a particular subsection. This addition is indicated by underscore of the term that identifies the subsection to which the example applies.

3. The regulation section number has been revised to read "25136-2." The regulation number itself was originally titled "25136(b)" to follow the numbering of the underlying statute for market-based rules of assignment of sales. However, in previous regulations, the Franchise Tax Board has used a dash-number system, i.e., California Code of Regulations, title 18, section 25137-1 et seq. This numbering system was adopted to avoid confusion with subsection "(a)" in the number of the regulation itself with a subsection "(a)" immediately following in the body of the regulation. As a result, this proposed new

regulation section number has been renumbered to "25136-2", with the "(b)" deleted. The cost of performance provisions in existing Regulation section 25136 will be renumbered to 25136-1 with a subsequent Form 100 change.

> §25136~~(b)~~ 2. Sales Factor. Sales Other than Sales of Tangible Personal Property in this State.

4. Subsection (a), In General, has been revised to add Revenue and Taxation Code section 25135 (sales of tangible personal property), and change the reference to Revenue and Taxation Code section "25136" to "25136(a)." Originally, this subsection was intended to define sales as other than those sales of tangible personal property under Revenue and Taxation Code section 25135 and sales determined under income-producing activity/cost of performance rules under Revenue and Taxation Code section 25136, subdivision (a). Instead, when drafted, Revenue and Taxation Code section 25135 was omitted entirely, and the income-producing activity/cost of performance rules were mistakenly referenced as Revenue and Taxation Code section "25136" and not "25136(a)." To clarify that assignment of both type sales are not governed by this regulation's market-based rules, a reference to Revenue and Taxation Code section 25135 for sales of tangible personal property was added and Revenue and Taxation Code section 25136 was identified correctly as "25136, subdivision (a)," to reference assignment of sales under the income producing activity/cost of performance rules.

> In General. Sales other than those described under Revenue and Taxation Code Sections ~~25136~~ 25135 and 25136, subdivision (a), are in this state if the taxpayer's market for the sales is in this state.

5. Subsection (b)(4), which provided the definition of "commercial domicile," has been deleted. In an earlier draft, commercial domicile appeared as one of the cascading rules. The only place where "commercial domicile" appears in the current draft is in some of the examples for the definition of "benefit of a service is received." The definition of commercial domicile has been deleted because it is no longer necessary and in order to avoid confusion as to whether it is one of the cascading rules.

> ~~(4) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.~~

6. Subsection (b) contains the definitions for the regulation's provisions. The terms being defined have been reorganized alphabetically such that "Benefit of the service is received" is (b)(1) and is followed by "Cannot be determined" as (b)(2), which is in turn followed by "Intangible property" at (b)(3), "Reasonably approximated" at (b)(4), "Service" at (b)(5), "The use of intangible property in this state" at (b)(6) and "to the extent" at (b)(7).

7. Subsection (b)(3)(B), which defines "non-marketing and manufacturing intangible," has been revised to include the language "or other non-marketing process" and insert the word "property" after the word "intangible." These changes were made so that the terms are accurately and consistently phrased throughout the regulation. Both terms should have been originally included in the definitional section "non-marketing and manufacturing intangible" but the language was inadvertently omitted.

(B) A "non-marketing and manufacturing intangible" includes, but is not limited to, the license of a patent, a copyright, or trade secret to be used in a manufacturing or other non-marketing process, where the value of the intangible property lies predominately in its use in such process.

8. Subsection (b)(3)(C), which defines "mixed intangible," was revised to list specific types of intangible property, i.e. "a patent, copyright, service mark, trademark, trade name, or trade secrets", and delete the general term "intangible property that includes both a license of a marketing intangible and a license of a non-marketing intangible." Listing specific types of intangible property is a preferable way to define intangible property rather than using general terms to define it. Also, the phrase "includes but is not limited to" has been inserted to make it clear that the list is non-exclusive. Lastly, an unnecessary space between the word "intangible" and a quote mark was removed.

(C) A "mixed intangible-" includes, but is not limited to, the license of a patent, copyright, service mark, trademark, trade name, or trade secrets ~~intangible property that includes both a license of a marketing intangible and a license of a non-marketing intangible~~ where the value lies both in the marketing of goods, services or other items as described in subparagraph (A) and in the manufacturing process or other non-marketing purpose as described in subparagraph (B).

9. Subsection (b)(4), which defines "reasonably approximated," a cascading rule for assignment of sales that appears in various subsections throughout this regulation, has been revised in several ways. In general, the definition has been broadened to indicate that reasonable approximation is limited to the jurisdiction or geographic area where the customer receives the benefit of the service or uses the intangible property. Also, if reasonable approximation is by population, it must be determined by U.S. population unless it can be shown by the taxpayer that the benefit is received or the intangible property is used materially in other parts of the world. These limitations originally appeared only in the reasonable approximation provisions for sales of intangible property but not in the definition or in the reasonable approximation provisions for sales of services. A commenter on this regulation suggested that at least the population language of the reasonable approximation provisions for sales of intangible property should be brought into the definitional language of reasonable approximation. Ultimately, it was felt that all limitations (not just the population limitations) that appeared in the reasonable approximation provisions for sales of intangible property should appear in the definition of reasonable approximation and apply to the entire regulation. As a result, all limitations now appear in the definition of "reasonable approximation" and have been deleted from the reasonable approximation provisions for sales of intangible property as redundant. The limitations apply when reasonably approximating both sales of services and sales of intangible property. Specific changes to the definition include the following.

First, the word "business" is exchanged for the word "activities." Originally, the term "reasonably approximated" was stated throughout the regulation with the proviso "that is consistent with the *activities* of the customer..." [emphasis added.] However, the definition originally read "that is consistent with the *business* of the customer..." [emphasis added.] Since some customers may not be business entities or a customer's business may be

irrelevant to the services rendered, it would be more appropriate to refer to the customer's "activities" in getting to the taxpayer's market.

Second, in other subsections of the regulation, reasonable approximation is to be determined "in a manner that is consistent with the activities of the customer" but limited by the proviso "to the extent such information is available to the taxpayer." This provision was intended to provide fairness to the taxpayer who may or may not have access to such information regarding its customer. However, while that language appeared throughout this regulation's provisions regarding reasonable approximation, that language did not appear in the definition. It has been inserted into the definition and removed from individual provisions as now redundant.

Third, geographic and/or jurisdictional limitations have been inserted for reasonably approximating where the benefit of the service has been received and the location of the use of the intangible property. The benefit of the service must be "substantially" received and the intangible property "materially" used in other parts of the world if those parts of the world are to be included in the population data for reasonable approximation. The purpose of such limitations is to ensure that only the actual market for the services or intangible property is considered in the reasonable approximation.

Fourth, population has been defined to be determined "by U.S. census data." This addition provides a method of determining population numbers. This change was made pursuant to a comment received for this regulation.

(4) "Reasonably approximated" means that, considering all sources of information other than the terms of the contract and the taxpayer's books and records kept in the normal course of business, the location of the market for the benefit of the services or the location of the use of the intangible property is determined in a manner that is consistent with the ~~business~~ activities of the customer to the extent such information is available to the taxpayer. Reasonable approximation shall be limited to the jurisdictions or geographic area where the customer or purchaser, at the time of purchase, will receive the benefit of the services or use the intangible property, to the extent such information is available to the taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population as determined by the most recent U.S. census data. If it can be shown by the taxpayer that the benefit of the service is being substantially received or intangible property is being materially used in other parts of the world, then the populations of those other countries where the benefit of the service is being substantially received or the intangible property is being materially used shall be added to the U.S. population. Information that is specific in nature is preferred over information that is general in nature.

10. Subsection (b)(6), which originally defined the term "Intangible personal property is used," has been revised so that the term being defined is worded exactly as it appears throughout the language in subsection (d). As a result, "intangible personal property is used" has replaced with "the use of intangible property in this state". In addition, the definition has been expanded to address new provisions, subsections (d)(1)(A)1 and (d)(1)(A)1.a and b, which have been added to the sale of intangible property in the case where the stock of a

corporation or an interest in a pass-through entity has been sold. Thus, language has been added to the definition to state that the location of the use of the intangible property is the location of the use of the underlying assets of the business entity sold.

(6) ~~"Intangible personal property is used"~~ "[T]he use of intangible property in this state" means the location where the intangible property is employed by the taxpayer's customer or licensee. In the case of the complete transfer of all property rights in stock of a corporation or interest in a pass-through entity, the location of the use of the stock of the corporation or interest in the pass-through entity is the location of the use of the underlying assets of the corporation or pass-through entity.

11. Subsections (c)(1) and (c)(1)(A) previously provided the first cascading rule for the assignment of sale of services to individuals. Now, (c)(1) has been revised so that it is a segue to the cascading rules for assignment of sales of services to individuals, which now appear below it in subsections (c)(1)(A) and (B). This format is cleaner and clearer: all cascading rule subsections are contained within the same subsection format, i.e. (c)(1)(A) and (c)(1)(B), and not as they were previously set forth, subsections (c)(1) and (c)(1)(A). Also, this format is consistent with those provisions for cascading rules in subsection (d) for sales of intangible property. The following specific changes have been made.

First, "receipt of" has been inserted in front of the words "the benefit of the service" to be consistent with the statutory language as well as other provisions of this regulation. Second, "determined as follows:" has been added to indicate this subsection as the segue for the cascading rules to come under subsections (c)(1)(A) and (B). Third, the language of the first cascading rule has been deleted.

(1) In the case where an individual is the taxpayer's customer, receipt of the benefit of the service shall be ~~presumed to be received at the billing address of the taxpayer's customer, as determined at the end of the taxable year. If the taxpayer uses the customer's billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this assignment~~ determined as follows:

12. Subsection (c)(1)(A) now contains the first cascading rule of assignment to the customer's billing address, previously set forth in subsection (c)(1). To be consistent with other subsections of this regulation, the subsection starts with "The location of the benefit of the service..." Then, the cascading rule is inserted immediately preceding the original language of subsection (c)(1)(A), which provided the method for overcoming the presumption that the billing address is the location where the benefit of the services is received.

Other modifications have been made to make the language consistent with other provisions of this regulation as well as other regulations. First, the phrase "in this state" was added to the first sentence of subsection (c)(1)(A) for clarification that the sale would be assigned to this state if the billing address were in this state. This was done to be consistent with the language of other subsections in this regulation as well as other Revenue and Taxation Code and Regulation sections. Typically, under Revenue and Taxation Code and Regulation sections, in connection with assignment of an item to a state under any of the apportionment factors, assignment will be made "in this state" as opposed to "California" or

any location in general. Second, "by" was replaced with "based on" for consistency with other similar provisions in this regulation. Third, "benefit of the" was added before the word "service" to be consistent with the statutory language. Fourth, "[P]erformed" was replaced by "received" also to be consistent with the statutory language and its market-based intent as well as to make this provision consistent with similar provisions in this regulation. This last change was made pursuant to a comment made at the hearing on this regulation.

(A) The location of the benefit of the service shall be presumed to be received in this state if the billing address of the taxpayer's customer, as determined at the end of the taxable year, is in this state. If the taxpayer uses the customer's billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this assignment. This presumption may be overcome by the taxpayer by showing, ~~by~~ based on a preponderance of the evidence, that either the contract between the taxpayer and the taxpayer's customer, or other books and records of the taxpayer kept in the normal course of business, provide the extent to which the benefit of the service is ~~performed~~ received at a location (or locations) in this state. If the taxpayer believes it has overcome the presumption and uses an alternative method based on either the contract between the taxpayer and the taxpayer's customer or other books and records of the taxpayer kept in the normal course of business, the Franchise Tax Board may examine the taxpayer's alternative method to determine if the billing address presumption has been overcome and, if so, whether the taxpayer's alternate method of assignment reasonably reflects where the benefit of the service was received by the taxpayer's customers.

13. Subsection (c)(1)(B) is the second cascading rule for the assignment of sales of services made to individuals. The first point of this second cascading rule is that the presumption in the first cascading rule, that the billing address is presumed to be the location where the benefit of the services are received, must be overcome prior to application of the second cascading rule, and, in addition, that there are no alternate methods that can be determined by looking at the contract with the customer or the taxpayer's books and records. To make the subsection clearer and consistent with the wording of other similar provisions in this regulation, "yet no" has been deleted and replaced with "and an" so that the sentence reads that if the presumption in the first cascading rule is overcome "and an alternate method cannot be determined..." then assignment shall be reasonably approximated. "Determined" is the preferred term in this context and is consistently used throughout this regulation and so replaces "derived." Finally, throughout this regulation when referring to the "taxpayer's contract with its customer or the taxpayer's books and records", the "taxpayer's contract with its customer" is listed first and the "taxpayer's books and records" is listed second. This subsection is modified to reflect that consistent order.

(B) If the presumption in (c)(1)(A)is overcome by the taxpayer, ~~yet no~~ and an alternative method cannot be ~~derived~~ determined by reference to the contract between the taxpayer and its customer or the taxpayer's books and records ~~of the taxpayer~~ kept in the normal course of business ~~or the contract between the taxpayer and its customer,~~ then the location where the

benefit of the services is received by the customer shall be reasonably approximated.

14. Subsection (c)(1)(C)1 provides an example of the assignment of sales of services to individuals. It has been completely revised to illustrate possible different facts in the case of sales of services within the telecommunications industry which facts would indicate that for some telecommunication taxpayers the billing address would not reflect the market of its consumers, and the market for telecommunications services might be more accurately determined by the net plant method of assigning sales consistent with the Franchise Tax Board's Multistate Audit Technical Manual section 7805. This amendment was requested by a commenter on this regulation.

1. ~~Phone Corp provides telecommunications services to individuals in this state and other states for a monthly fee billed to the customer's address. Gross receipts from these services are assigned to this state if the billing address of the customer is in this state.~~

   Benefit of a Service – Individual, subsection (c)(1)(A). Phone Corp provides interstate communications and wireless services to individuals in this state and other states for a monthly fee. The vast majority of consumers of mobile services receive the benefit of the services at many locations. As a result, a customer's billing address may not be reflective of the location where the benefit of the services is received by the customer. Phone Corp has net plant facilities located in geographical areas where customers utilize its services, based on market size and demand. Phone Corp's books and records, kept in the normal course of the business, identify the net plant facilities used in providing the communications services to Phone Corp's customers. Because Phone Corp's books and records show where the benefit of the services is actually received, the presumption of billing address is overcome. Receipts from interstate communications and wireless services may be attributable to this state based upon the ratio of California net plant facilities over total net plant facilities used to provide those services. Revenues from interstate and international calls may be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call.

15. Subsection(c)(1)(C)2 is another example for assignment of sales of services to individuals. Originally, the second paragraph of this example had not been numbered or lettered. The second paragraph has now been pulled up into the first paragraph, subsection (c)(1)(C)2. This change was made for clarity and consistency with other examples within this regulation.

In addition, the example has been revised in several other ways. First, the phrase "books and" has been inserted in front of the word "records." This term with the inserted words is consistent with other similar provisions throughout this regulation and other Revenue and Taxation Code and Regulation provisions. Second, after the word "records" the phrase "maintained in the regular course of business" was inserted. The phrase "books and records"

usually appears with the modifying phrase "maintained in the regular course of business" when initially referred to in a subsection. This is consistent with other provisions throughout this regulation as well as other Revenue and Taxation Code and Regulation sections. However, when the term "books and records" is mentioned a second time in the same subsection, the modifying term "maintained in the regular course of business" need not appear, as it is generally understood that the books and records are the same books and records identified earlier in the subsection. As a result, the second reference to "maintained in the regular course of business" in this subsection was deleted.

2. Benefit of the Service – Individual, subsection (c)(1)(A). Travel Support Corp located in this state provides travel information services to its customers, who are individuals located throughout the United States, through a call center located in this state. The contract between Travel Support Corp and its customers provides that for a fee per call, the customer can call Travel Support Corp for information regarding hotels, restaurants and other travel related information. Travel Support Corp's books and records maintained in the regular course of business indicate that fifteen (15) percent of its customers have billing addresses in this state. However, Travel Support Corp's books and records~~, maintained in the regular course of business,~~ indicate that only seven (7) percent of the calls handled by the call center originate from this state. Because Travel Support Corp's books and records show where the benefit of the services is actually received, the billing address presumption is overcome and the books and records of the taxpayer may be used to assign seven (7) percent of the gross receipts from the support services provided by the call center to this state.

16. Subsection (c)(1)(C)3 is an example of when a taxpayer may not overcome the presumption that the billing address is the location where the benefit was received. This example was revised to give a reason as to why the presumption was not overcome. After the language "The fact that only seven (7) percent of the calls originate from this state does not overcome the presumption that the benefit of the services is received at the billing address", the statement "This is because the charges are not based on a per call basis but rather a flat monthly fee" was added.

3. Benefit of the Service – Individual, subsection (c)(1)(A). Same facts as Example 2 except the contract between Travel Support Corp and its customers provides for a set monthly fee, regardless of whether the customer actually calls for travel support. This is because the charges are not based on a per call basis but rather a flat monthly fee.

17. Subsection (c)(1)(C)4 was inserted to provide an example as to how the cascading rule of reasonable approximation for sales of services to an individual works. It has been identified as "Benefit of the Service – Individual, subsection (c)(1)(B)." An example of this cascading rule had not been provided in previous drafts. It is the intent of the Department to provide at least one example for every cascading rule to show how each rule works.

4. Benefit of the Service – Individual, subsection (c)(1)(B). Satellite Music Corp has a contract with Car Dealer Corp to provide satellite music service to Car Dealer Corp's retail customers who buy Make and

Model X car. Car Dealer Corp's customers pre-pay for a two (2) year service plan to receive satellite music at a discounted rate as part of the purchase price of the Make and Model X car. While Satellite Music Corp requires an email address for Car Dealer Corp's customers who receive the benefit of this service, Satellite Music Corp does not have access to information as to the billing address or physical location of Car Dealer Corp's customers. Satellite Music Corp may reasonably approximate the location where Car Dealer Corp's customers receive the benefit of its satellite music service by a ratio of the number of Car Dealer Corp locations that offer the two (2) year service plan with Satellite Music Corp to its customers in this state to the number of Car Dealer Corp locations that offer the two (2) year service plan with Satellite Music Corp to its customers located everywhere.

18. Subsections (c)(2) and (c)(2)(A) originally provided the first cascading rule for sales of services to business entities. Now (c)(2) has been revised so that it is a segue to the cascading rules for assignment of sales of services to business entities that appear below it in (A) through (D). This type of format is cleaner and clearer: all cascading rule subsections are contained within the same subsection, i.e. (A) through (D) and not as they were previously set forth in subsection (c)(2), i.e. (2) and (2) (A) through (C). Also, this format is consistent with the provisions for cascading rules in (d), sales of intangible property.

In subsection (c)(2), several changes have been made. First, "receipt of" has been inserted in front of the words "the benefit of the service" to be consistent with the statutory language as well as other provisions of this regulation. Second, "determined as follows:" has been added to indicate this subsection is the segue for the cascading rules to come under subsections (A) through (D) in connection with assignment of sales of services to business entities. Third, the language of the first cascading rule that assignment will be determined by the contract with the customer or the taxpayer's books and records has been deleted.

(2) In the case where a corporation or other business entity is the taxpayer's customer, receipt of the benefit of the service shall be ~~presumed to be received at the location (or locations) indicated by the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records, notwithstanding the billing address of the taxpayer's customer~~ determined as follows:

19. Subsection (c)(2)(A) now contains the first cascading rule of assignment based on the contracts with the customer or the taxpayer's books and records previously set forth in (c)(2). In addition, this rule was modified so that the language is consistent with other provisions in this regulation and other regulations. Hence, the provision starts with "The location of the benefit of the service..." Then, the cascading rule is inserted immediately preceding the original language of subsection (c)(2)(A) on how a taxpayer may overcome the presumption that the contract or the taxpayer's books and records indicates the location where the benefit of the services is received. Lastly, "upon an evidentiary showing" was deleted and inserted after "by" is "showing based on" also to be consistent with other similar provisions of the regulation. Commas were added where appropriate in that same sentence.

(A) ~~To the extent that the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records (notwithstanding the billing address of the taxpayer's customer) kept in the normal course of business provide the location (or locations) where the benefit of the services is received, such location (or locations) will be presumed to be where the benefit of the service is actually received.~~ The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer's customer, indicate the benefit of the service is in this state. This presumption may be overcome by the taxpayer or the Franchise Tax Board ~~upon an evidentiary showing~~ by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.

20. Subsection (c)(2)(C), the third cascading rule for assignment of sales of services to business entities, has been revised to insert the phrases "in this state if" and "is in the state" to be consistent with the language of other subsections in this regulation as well as other Revenue and Taxation Code and Regulation sections. Typically, under the Revenue and Taxation Code and other Regulations, in connection with assignment of an item to a state under any of the apportionment factors, assignment will be made "in this state" as opposed to "California" or any location in general. Insertion of the phrase, "is in this state", at the end of the sentence completes the sentence.

(C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or reasonably approximated under subparagraph (B), then the location where the benefit of the service is received shall be presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state.

21. Subsection (c)(2)(E)3 provides an example for the first cascading rule for sales of services to business entities and provides guidance on how either the contract between the taxpayer and its customer or a taxpayer's books and records can determine the location where the benefit of the services was received by a business entity customer. The word "its" was exchanged for the term "Client Corp's" so that the facts are clearer.

3. Benefit of the Service – Business Entity, subsection (c)(2)(A). Audit Corp is located in this state and provides accounting, attest, consulting, and tax services for Client Corp. The contract between Audit Corp and Client Corp provides that Audit Corp is to audit Client Corp for taxable year ended 20XX. Client Corp's books and records kept in the normal course of business, as well as ~~its~~ Client Corp's internal controls and assets, are located in States A, B and this state. As a result, Audit Corp's staff will perform the audit activities in States A, B and this state. Audit Corp's business books and records track hours worked by location where its employees performed their service. Audit Corp's receipts are attributable to this state and States A and B

according to the taxpayer's books and records which indicate time spent in each state by each staff member.

22. Subsections (c)(2)(E)4 and 5 are examples based on similar facts exhibiting how the books and records cascading rule and the reasonable approximation cascading rule works for sale of services to business entities. Originally, the first paragraph under (c)(2)(E)4 was numbered 4.a and the second paragraph was numbered 4.b. To be consistent with other examples throughout the regulation, the provision "a" was moved up into 4, making 4 and 4.a one example. Then, "b" was renumbered "5" as its own example. Because "5" is now its own example, the language "Same facts as in Example 4 except" was added to the beginning of the example. This format is also consistent with other examples in this regulation. Secondly, since for purposes of this particular example the term "viewers" is more accurate than "subscribers", "subscribers" was substituted for "viewers".

4. Benefit of the Service – Business Entity, subsection (c)(2)(A). Web Corp provides internet content to its viewers and receives revenue from providing advertising services to other businesses. Web Corp's contracts with other businesses do not indicate the location (or locations) where the benefit of the service is received. The advertisements are shown via the website to Web Corp viewers and the fee collected is determined by reference to the number of times the advertisement is viewed and/or clicked on by viewers of the website. ~~a.~~ If Web Corp, through its books and records kept in the normal course of business, can determine the location from which the advertisement is viewed and/or clicked on by viewers of the website, then gross receipts from the advertising will be assigned to this state by a ratio of the number of viewings and/or clicks of the advertisement in this state to the total number of viewings and/or clicks on the advertisement.

~~b.~~5. Benefit of the Service – Business Entity, subsection (c)(2)(B). Same facts as Example 4~~.~~ except ~~If~~ Web Corp cannot determine the location from which the advertisement is viewed and/or clicked on through its books and records, it shall reasonably approximate the location of the receipt of the benefit by assigning its gross receipts from advertising by a ratio of the number of its viewers in this state to the number of its ~~subscribers~~ viewers everywhere.

23. Subsection (c)(2)(E)6 and 7 are examples with the same facts that show how the third and fourth cascading rules for sales of services to business entities work in the event the first cascading rule (the contract between the taxpayer and the customer or the taxpayer's books and records) and the second cascading rule (reasonable approximation) do not provide a method for determining where the location of the receipt of the benefit of the service, i.e. where the customer has received value from delivery of the service (see definition of "Benefit of a service is received" subsection (b)(1).) Several changes have been made to these examples.

First, what used to be subsection (c)(2)(E)6.a has been brought into what is now subsection (c)(2)(E)6, making the subsections of 6 and 6.a one example. What used to be subsection (c)(2)(E)6.b has been renumbered to 7 and made its own example. Because "7" is now its own example, the phrase "Same facts as Example 6" has been added to the beginning of the example. These changes were made for clarity and consistency with the other examples throughout the regulation.

Second, to make it clearer in this example that the first two cascading rules do not provide a method for determining how much value Western Corp received from Painting Corp's painting services delivered in this state, additional critical factors (shape and surface of the buildings to be painted, and materials used) have been added as necessary facts which are missing so that determination of this state's receipt of its pro-rata portion of value of the painting service under the first two cascading rules is not possible. The "number" factor was deleted because that fact would be known since the location of the buildings is known. "At each location" was deleted as unnecessary. These facts were added or deleted based on comments received for this regulation that assignment could be reasonably approximated.

Third, while it is stated in the example that neither the contract between Painting Corp and Western Corp nor Painting Corp's books and records (the first cascading rule) indicate any method for determination of the extent that the benefit of the services was received in this state, the example failed to specifically mention that there is also no method of reasonable approximation (the second cascading rule) of the extent the benefit of the services was received in this state. It is important that it is clearly stated that the first two cascading rules do not determine assignment of the sale because only then does the next cascading rule apply. As a result, the language "In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received" has been added to the example. This language allows application of the third cascading rule (the place from which the order was made), which is the purpose of example of (c)(2)(E)6.

If a taxpayer cannot assign the sale to the place from which the order was made (the third cascading rule) then it is assigned to the customer's billing address (the fourth cascading rule) which is the purpose of the example (c)(2)(E)7. The example has been modified to state "subsection (c)(2)(C)" instead of "subparagraph a" to reflect how it is currently numbered.

6. Benefit of the Service – Business Entity, subsection (c)(2)(C). For a flat fee, Painting Corp ~~a~~ contracts with Western Corp to paint Western Corp's various sized, shaped and surfaced buildings located in this state and four (4) other states. The contract does not break down the cost of the painting per building or per state. Painting Corp's books and records kept in the normal course of business indicate the location of the buildings that are to be painted but do not provide any method for determining or reasonably approximating the extent that the benefit of the service is received in this state, i.e. the size, shape, or ~~number~~ surface of each building~~s~~, or the materials used for each building~~s~~ to be painted ~~at each location~~. In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received. ~~a.~~ Since neither the contract nor Painting Corp's

books and records indicate how much of the fee is attributable to this state and there is no method of reasonably approximating the location of where the benefit of the service is received, the sale will be assigned to this state if the order for the service was placed from this state.

~~b.~~7~~.~~ Benefit of the Service – Business Entity, subsection (c)(2)(D). Same facts as Example 6~~.~~ ~~If~~ except the sale cannot be assigned under ~~subparagraph a.~~ subsection (c)(2)(C), then the sale shall be assigned to this state if Western Corp's billing address is in this state.

24. Subsection (d)(1), the segue for the first cascading rule for sales of intangible property where there has been a complete transfer of all property rights, has been revised to be consistent with the underlying statute, which provides that assignment of sales of intangibles shall be based on the location of the use of the intangible property. As a result, the phrase "location of the use of the" has been inserted before "the intangible property" for purposes of being consistent with the underlying statute. Consequently, the phrase "in this state" has been deleted as unnecessary as it appears in the cascading rules below. This is consistent with other provisions in this regulation.

(1) In the case of the complete transfer of all property rights in intangible property as defined in subsection (b)(~~5~~3), for a jurisdiction or jurisdictions, the location of the use of the intangible property ~~in this state~~ shall be determined as follows:

25. Subsection (d)(1)(A), the first cascading rule for sales of intangible property where there has been a complete transfer of all property rights, has been modified.

First, the phrase "location of the use of the intangible property shall be presumed to be in this state to the extent the" was added to the beginning of the subsection to be consistent with the wording of similar presumptive language in the provisions for assignment of sales of services in subsection (c). Further down in the same sentence, the phrase "shall be presumed to provide where the purchaser will use the intangible at the time of the purchase" was deleted accordingly. Also in the first sentence, the word "indicate" replaces the word "provide" to be consistent with the wording of the provisions for assignment of sales of services in subsection (c). For clarity, the phrase "that the intangible property is used" was inserted before "in this state", and "at the time of sale" was added to the end of the sentence.

In the second sentence, the two words "books and" were added before the word "records" to complete the phrase as it is generally known and so that the term is consistently worded throughout this regulation. Also, "for the most recent twelve (12) month taxable year" was added in order to identify the time period for determining the extent of the use of the intangible property in this state by the taxpayer prior to the sale.

In the third sentence, to be consistent in the wording with other similar provisions in this regulation, the phrase "showing based on" was added prior to the phrase, "preponderance of the evidence" and "showing" was deleted immediately after "preponderance of the evidence."

In the final sentence, for clarity, the term "actual location of the use" was put in place of "purchaser's use" and the phrase "property by the purchaser" was added after the word "intangible" so it now reads "the actual location of the use of the intangible property by the purchaser..." The term "intangible property" was originally referred to here as only "intangible", hence the word "property" was added to "intangible" to complete the term as it is generally known. Commas have been added where appropriate. As a result of rephrasing this sentence, "showing" and "purchaser's use" were deleted.

(A) The location of the use of the intangible property shall be presumed to be in this state to the extent that the contract between the taxpayer and the purchaser, or the taxpayer's books and records kept in the normal course of business~~, shall be presumed to~~ indicate ~~provide where the purchaser will use the intangible at the time of purchase~~ that the intangible property is used ~~it is~~ in this state at the time of the sale. This may include books and records providing the extent that the intangible property is used in this state by the taxpayer for the most recent twelve (12) month taxable year prior to the time of the sale of the intangible property. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, ~~showing~~ that the actual location of the use ~~purchaser's use~~ of the intangible property by the purchaser at the time of purchase is not consistent with the terms of the contract or the taxpayer's books and records.

26. Subsections (d)(1)(A)1, (d)(1)(A)1.a and (d)(1)(A)1.b are assignment rules for sales of intangible property in the event of a sale of an interest in a corporation or a pass-through entity. Subsection (d)(1)(A)1.a was originally set out as an example for the sale of stock (see subsection (d)(1)(D)(1), strikeout version.)

At the hearing for this regulation, comments were received that (1) it is better tax policy to set forth the law in statutory or regulatory provisions instead of by example, (2) sales of interests in pass-through entities should be included, (3) a separate provision should be created for sales of interests where the underlying assets consist of more than 50% intangible property whereby assignment of the sale of the interest should be based on the principles in Revenue and Taxation Code section 25125, subdivision (d), and (4) in calculating the assignment of the sale, the average of the factors referred to in subsection (d)(1)(A)1.a and the sales factor referred to in subsection (d)(1)(A)1.b should be determined by the most recent 12-month taxable year prior to the time of the sale. As a result of these comments, assignment mechanism rules for a sale of stock in a corporation or an ownership interest in a pass-through entity were created in subsections (d)(1)(A)1.a and (d)(1)(A)1.b.

Subsection (d)(1)(A)1 was created as a segue for the rules set forth in (d)(1)(A)1.a and (d)(1)(A)1.b. This is consistent with the provisions in subsection (c).

Subsection (d)(1)(A)1.a reflects the principles of the example originally set out in (d)(1)(D)1 and incorporates the comments received. That subsection states that in the event of a sale of stock in a corporation or an ownership interest in a pass-through entity where 50% or more of the amount of the assets of the corporation or pass-through entity, determined

using the original cost basis, consist of real and/or tangible personal property, the sale will be assigned by averaging the California payroll and property factors of the entity sold. The average of the factors will be determined by the most recent 12-month taxable year prior to the time of sale according to the taxpayer's books and records. It is felt that the payroll and property factors reflect the value and location of where the intangible property, the underlying assets of the entity sold, was employed (see definition of "the use of the intangible property," subsection (b)(6)) at the time of the sale and therefore is an appropriate way to assign the sale of intangible property where 50% or more of the underlying assets consist of real and/or tangible personal property.

Subsection (d)(1)(A)1.b was created to provide for assignment of a sale of stock in a corporation or an ownership interest in a pass-through entity where more than 50% of the amount of the corporation's or pass-through entity's underlying assets, determined by using the original cost basis, consist of intangible property. This subsection states that the sale will be assigned by using the California sales factor of the entity sold for the most recent 12-month tax period prior to the time of sale according to the taxpayer's books and records. This entire subsection is based on comments received at the hearing. Here, the sales factor reflects the value and location of where the intangible property, such as goodwill, was employed (see definition of "the use of intangible property," subsection (b)(6)) at the time of sale, and, as a result, is an appropriate way to determine assignment of sale of stock or ownership interest where the majority of the underlying assets consist of intangible property.

1. Where the sale of intangible property is the sale of stock in a corporation or the sale of an ownership interest in a pass-through entity the following rules apply:

a. In the event that fifty (50) % or more of the amount of the assets of the corporation or pass-through entity sold, determined using the original cost basis of those assets, consist of real and/or tangible personal property, the sale of the stock or ownership interest will be assigned by averaging the payroll and property factors of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records kept in the normal course of business.

b. In the event that more than fifty (50) % of the amount of the assets of the corporation or pass-through entity sold, determined using the original costs basis of those assets, consist of intangible property, the sale of the stock or ownership interest will be assigned by using the sales factor of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records.

27. Subsection (d)(1)(B), the second cascading rule of reasonable approximation for sales of intangible property where there has been a complete transfer of all property rights, has been modified to delete the conditions and limitations for reasonable approximation because those conditions and limitations have been moved to the general definition of reasonable approximation at subsection (b)(4), thereby making them applicable to all provisions in this regulation.

(B) If the extent of the use of the intangible property in this state cannot be determined under subparagraph (A) or the presumption under subparagraph (A) is overcome, the location where the intangible property is used shall be reasonably approximated. ~~by reference to the activities of the purchaser, limited to the jurisdictions where the purchaser, at the time of purchase, will use the intangible, to the extent such information is available to the taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population, unless it can be shown by the taxpayer that the intangible is being used materially in other parts of the world. If this is shown then only the populations of those other countries where the intangible is being materially used shall be added to the U.S. population~~.

28. Subsection (d)(1)(C) is the third cascading rule. This rule provides that if the taxpayer cannot apply the rules in (d)(1)(A) or (d)(1)(B), that the location of the customer's billing address will be used to assign sales of intangible property where there has been a complete transfer of all property rights. This rule has been modified to reflect the standard assignment language found in other sections of the Revenue and Taxation Code and Regulations. Typically, assignment will be made "to this state" as opposed to "California" or any location in general. As a result, the words "this state if" were inserted after the phrase "the gross receipts shall be assigned to". Secondly, after the phrase "the billing address of the purchaser" the phrase "is in this state" was added.

(C) If the extent of the use of the intangible property in this state cannot be determined pursuant to subparagraphs (A) or (B), then the gross receipts shall be assigned to <u>this state if</u> the billing address of the purchaser <u>is in this state.</u>

29. Subsection (d)(1)(D)1 is an example showing the application of the cascading rule for assigning a sale of an interest in a corporation or pass-through entity where 50% or more of the amount of the underlying assets, determined by using the original cost basis, are real or tangible personal property. Language was added to indicate that this example addresses the provision where the underlying assets of the corporation or entity sold consist of predominantly tangible personal property. "[A]t the time of sale" was moved to the beginning of the sentence to address both the new language and the first sentence. The phrase, "in its most recent 12-month taxable year preceding the sale", has been inserted to define the time period that the payroll and property factors are to be averaged for determining assignment of the sale of stock.

~~(1)~~ <u>1. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.a.</u> Parent Corp sells all of the of stock of Subsidiary Corp. <u>At</u>

the time of sale, the predominant value of Subsidiary Corp's assets consists of tangible personal property and~~.~~ Subsidiary Corp~~, at the time of sale,~~ had locations in this state and three (3) other states. Taxpayer's books and records indicate Subsidiary Corp had payroll and property in this state of 15% and 25%, respectively, in its twelve (12) month taxable year preceding the sale. In assigning the receipt from the sale of Subsidiary Corp. Taxpayer may average the property and payroll percentages and assign 20% of the receipt from the sale to this state.

30. Subsection (d)(1)(D)2 has been inserted as an example of the cascading rule in subsection (d)(1)(A)1.b of assigning the sale of stock of a corporation or an interest in a pass-through entity where more than 50% of the amount of the underlying assets, determined by using the original cost basis, is intangible property.

~~(2)~~ 2. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.a. Parent Corp sells an interest in Target Entity. At the time of the sale, the predominant value (over 50%) of Target Entity's assets consists of intangible property. Target Entity's books and records indicate that 30% of Target Entity's sales were assigned to California during the most recent full tax period preceding the sale. Parent Corp may assign 30% of the receipt from the sale of the interest in Target Entity to this state.

31. Subsection (d)(1)(D)3 is an example of the second cascading rule of reasonable approximation for assigning sales of intangible property where a complete transfer of all property rights has been made. This example has been clarified by renaming the corporations by what they do. This is consistent with all other examples in this regulation. As a result, "Taxpayer" has been replaced with "R&D Corp", and "Buyer" has been replaced with "Manu." Also, because this example is intended to show how a taxpayer may reasonably approximate the location of the use of the intangible property, the words "may reasonably approximate the location of the use by assigning" have been inserted in place of the word, "assigns" for clarity.

~~(3)~~3. Intangible Property – Complete Transfer, subsection (d)(1)(B). ~~Taxpayer~~ R&D Corp sells a patent to ~~Buyer~~ Manu Corp that will be used by ~~Buyer~~ Manu Corp to manufacture products for sale in the United States. The contract between ~~Taxpayer~~ R&D Corp and ~~Buyer~~ Manu Corp indicates that ~~Buyer~~ Manu Corp will have the exclusive rights to the patent for exploitation in the United States. At the time of the purchase, ~~Taxpayer~~ R&D Corp knows that ~~Buyer~~ Manu Corp has three factories that will use the patented process in manufacturing, one of which is located in this state. In the absence of specific information as to the amount of manufacturing ~~Buyer~~ Manu Corp does at each of the three locations, ~~Taxpayer~~ R&D Corp may reasonably approximate the location of the use by assigning ~~assigns~~ the receipts from the sale equally among the three states where ~~Buyer~~ Manu Corp has manufacturing plants, assigning 33% of the sale to this state.

32. Subsection (d)(1)(D)4 is an example of the third cascading rule. This rule provides that the customer's billing address shall be used for assigning sales of intangible property in the case of a complete transfer of all property rights. This example has been clarified by renaming the corporations by what they do. This is consistent with all other examples in this regulation. As a result, "Taxpayer" has been replaced with "R&D Corp" and "Buyer" has been replaced with "Manu." Also, the word "facts" has been added for clarity. "[S]hall" replaces "may" and "except" replaces "but" to be consistent with other similar provisions in this regulation.

> ~~(1)~~ 4. Intangible Property – Complete Transfer, subsection (d)(1)(C). Same facts as Example ~~(3)~~, ~~but~~ ~~Taxpayer~~ except R&D Corp has no information regarding ~~Buyer~~ Manu Corp's activities. ~~Taxpayer~~ R&D Corp ~~may~~ shall assign the receipt to the billing address of ~~Buyer~~ Manu Corp.

33. Subsection (d)(2)(A)1 is the provision for assignment of sales where the intangible property sold is a "marketing intangible." A commenter for this regulation suggested that the language was duplicative, and, therefore by implication, also unclear. As a result of the comment, changes have been made to clearly articulate the 3 prongs of this marketing intangible provision. The three prongs are: (1) sales are assigned to this state to the extent the ultimate customer of the goods or services to which licensing fees are attributed is in this state, (2) the contract between the taxpayer and licensee or the taxpayer's books and records are presumed to indicate the method for determination of the ultimate customer in this state, and (3) the presumption of the contract or books and records may be overcome based on a preponderance of the evidence.

In connection with the first prong (sales are assigned based on location of ultimate customer), there have been several changes made for clarity. First, the subsection originally contained one long sentence which included the provisions for both the first prong and the second prong. Now, the two prongs have been divided into two separate sentences. The first prong is the first sentence of this subsection and provides the general rule for assignment of sales for marketing intangibles. The second prong is the second sentence and provides the presumptive first cascading rule on how to assign such sales (discussed infra). In the first sentence, the word "ultimate" was added preceding "customer" to make it clear that it is the ultimate customer that determines the location of assignment of the sale. Also, the phrase "presumed to be" was deleted as unnecessary because the first cascading rule (contract or books and records are presumed to indicate the method of location of the ultimate customer) to which the presumption was intended to attach is now in the second sentence.

In connection with the second prong (the contract or books and records are presumed to indicate the method of location of the ultimate customer), the presumption language itself has been rephrased so that it is clearer and consistent with other similar provisions in this regulation. In addition, based on comments received, language clearly stating that the contract or books and records "are presumed" to provide a method for determination of the location of the ultimate customers has been inserted. Also, as in the previous sentence, the word "ultimate" is inserted before "customers" for purposes of clarity. This prong is represented in the second sentence of this subsection.

In connection with the third prong (overcoming the presumption), previously there was no language as to how the presumption could be overcome (thereby allowing application of the second cascading rule of reasonable approximation which appears in the following subsection). Language as to how to overcome the presumption was added as the third sentence to this subsection. It is consistent with other similar provisions in this regulation.

1. Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items, the royalties or other licensing fees paid by the licensee for such right(s) ~~are presumed to be~~ attributable to this state to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by ~~this states~~ ultimate customers in this state.~~, as is provided for by the terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business. If~~ The contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to provide a method for determination of ~~this state's~~ the ultimate customers in this state for the purchase of goods, services, or other items in connection with the use of the intangible property~~, then the contract's terms or the taxpayer's books and records shall be used to determine this state's customers for the purchase of goods, services, or other items in connection with the use of the intangible property~~. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing based on a preponderance of the evidence that the ultimate customers in this state are not determinable under the contract or the taxpayer's books and records.

34. Subsections(d)(2)(A)2 provides the second cascading rule for assignment of "marketing intangibles" which states that if assignment cannot be made under the previous provision, then assignment shall be done by reasonable approximation. This subsection was reworded to be consistent with other similar provisions in the regulation, including the addition that if the presumption in the preceding paragraph is overcome, then the location of the use of the intangible property shall be reasonably approximated. This subsection has been modified to delete the conditions and limitations of reasonable approximation because those conditions and limitations have been inserted into the general definition of reasonable approximation in subsection (b)(4), thereby making them applicable to all provisions in this regulation.

Finally, the last sentence provides factors to consider in determining the customer's or licensee's use of "marketing intangibles." This provision was originally located under "Special Rules" in subsection (g)(2) and applicable to the regulation as a whole. However, the rule is specific to assignment of sales of "marketing intangibles" and therefore was relocated to the provision for the first cascading rule for assignment of "marketing intangibles." The phrase "including population" was deleted as unnecessary. For clarity, other changes were made and include replacing "intangible property" with "marketing intangibles" and deleting "for use of marketing intangibles".

2. If the location of the use of the intangible property is not determinable under subparagraph 1 or the presumption under subparagraph 1 is overcome, the location of the use of the intangible property shall be reasonably approximated. ~~by reference to the activities of the taxpayer's licensee customer to the extent such information is available to the taxpayer. Reasonable approximation of the location of the use of the intangible property includes, but is not limited to, the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items, to the extent such information is available to the taxpayer.~~ To determine the customer's or licensee's use of ~~intangible property~~ marketing intangibles in this state ~~under subsection (d)(2)(A)2 for use of marketing intangibles~~, factors that may be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state, or other data ~~including population~~ that reflects the relative usage of the intangible property in this state.

35. Subsection (d)(2)(A)3 is a population assignment provision specific for marketing intangibles sold at the wholesale level. The assignment language was modified to be consistent with the language for the use of population as a method of assignment in the definition of reasonable approximation in subsection (b)(4).

3. Where the license of a marketing intangible property is for the right to use the intangible property in connection with sales or other transfers at wholesale rather than directly to retail customers, the taxpayer may be unable to develop information regarding the location of the ultimate use of the intangible property. If this is the case, then the taxpayer may attribute the receipt to this state based solely upon the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items. ~~Only the populations of those countries where the intangible is being materially used shall be taken into account.~~ The population used shall be the U.S. population, unless it can be shown by the taxpayer that the intangible property is being used materially in other parts of the world. If this is shown then only the populations of those other countries where the intangible is being materially used shall be added to the U.S. population.

36. Subsection (d)(2)(B)1 is the first cascading rule regarding non-marketing or manufacturing intangibles. For consistency purposes, the provision was changed to mirror the first cascading rule of marketing intangibles in subsection (d)(2)(A)1. Thus, the first sentence provides the general rule for assignment of non-marketing/manufacturing sales, and the second sentence contains the presumptive first cascading rule on how to assign such sales. The third sentence is now consistent with marketing intangibles and other similar provisions in the regulation and provides language on overcoming a presumption. Thus, "by a preponderance of the evidence" was deleted and "by showing, based on a preponderance of the evidence, that the extent of the use for which the fees are paid are

not determinable under the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records" was inserted in its place.

(B) Non-marketing and manufacturing intangibles.

1. Where a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, the licensing fees paid by the licensee for such right(s) are ~~presumed to be~~ attributable to this state to the extent that the use for which the fees are paid takes place in this state~~, as is provided for by~~. ~~t~~The terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to~~. If the contract or the taxpayer's books and records~~ provide a method for determination of the extent of the use of the intangible property in this state~~, then the contract's terms or the taxpayer's books and records will be presumed to properly indicate the extent of the use of the intangible property in this state~~. This presumption may be overcome ~~by~~ ~~a preponderance of the evidence~~ by the taxpayer or the Franchise Tax Board by showing, based on preponderance of evidence, that the extent of the use for which the fees are paid are not determinable under the contract or the taxpayer's books and records.

37. Subsection (d)(2)(B)2 provides the second cascading rule for the assignment of sales of non-marketing and manufacturing intangibles. The phrase "for which the fees are paid" was deleted as unnecessary and inconsistent with the language of similar provisions in the regulation. Finally, this subsection has been modified to delete the conditions and limitations of reasonable approximation because those conditions and limitations have been moved to the general definition of reasonable approximations at subsection (b)(4), making them applicable to all provisions of this regulation.

2. If the location of the use of the intangible property ~~for which the fees are paid~~ cannot be determined under subparagraph 1 or the presumption in subparagraph 1 is overcome, then the location of the use of the intangible property shall be reasonably approximated. ~~by reference to the activities of the taxpayer's customer, to the extent such information is available to the taxpayer.~~

38. Subsection (d)(2)(C)1 is the first cascading rule for assignment of sales of mixed intangibles. For clarity, the single word "Where" was replaced with the phrase "Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing or manufacturing intangible and..." in the last sentence "or manufacturing" was added to "non-marketing" to complete the term, mixed intangibles, as it is defined in subsection (b)(3)(C).

(C) Mixed intangibles.

1. Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing or manufacturing intangible and the fees to be paid in each instance are separately stated in the licensing contract, the Franchise Tax Board will accept such separate statement for purposes of this section if it is reasonable. If the Franchise Tax Board determines that the separate statement is not reasonable, then the Franchise Tax Board may assign the fees using a reasonable method that accurately reflects the licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible.

39. Subsection (d)(2)(C)2 is the second cascading rule for assignment of sales of mixed intangibles. The phrase "a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible" is unnecessary as the definitional language of a mixed intangible already appears immediately above in subsection (d)(2)(C)1. Since this second rule immediately follows the first rule, it is unnecessary to define the term again. Finally, the language on how to overcome the presumption has been added to the end of this provision. This is consistent with other similar subsections of this regulation.

2. Where ~~a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible and~~ the fees to be paid in each instance are not separately stated in the contract, it shall be presumed that the licensing fees are paid entirely for the license of a marketing intangible except to the extent that the taxpayer or the Franchise Tax Board can reasonably establish otherwise. This presumption may be overcome, by a preponderance of the evidence, by the taxpayer or the Franchise Tax Board, that the licensing fees are paid for both the licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible, and the extent to which the fees represent the marketing intangible and the non-marketing or manufacturing intangible.

40. Subsection (d)(2)(D)2 is an example for reasonable approximation for assigning sales of marketing intangibles." "Sports" replaces "Whole" to give the corporation in the example a clearer identity so that the example is easier to understand. In addition, to make it clear that the taxpayer could not determine assignment based on the first cascading rule (the contract or the taxpayer's books and records), language is inserted to state that fact: "Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks." Finally, to make it clear that this is a reasonable approximation example, the word "determined" is replaced with the term "reasonably approximated."

2. Intangible Property – Marketing Intangible, subsection (d)(2)(A)1. ~~Marketing intangible~~. Moniker Corp enters into a license agreement with ~~Whole~~ Sports Corp where ~~Whole~~ Sports Corp is granted the right to use trademarks owned by Moniker Corp to brand sports equipment

that is to be manufactured by ~~Whole~~ Sports Corp or an unrelated entity, and to sell the manufactured product to unrelated companies that make retail sales in a specified geographic region. Although the trademarks in question will be affixed to the tangible property to be manufactured, the license agreement confers a license of a marketing intangible. Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks. The component of the licensing fee that constitutes sales of Moniker Corp in this state is ~~determined~~ reasonably approximated by multiplying the amount of the fee by the percentage of this state's population over the total population in the specified geographic region in which the retail sales are made.

41. Subsection (d)(2)(D)3 is an example for the assignment of sales of a marketing intangible where the sale is to a wholesaler. The previous draft did not contain a wholesale example. As stated above, it is the intent to provide an example to show how each rule in this regulation works.

3. Intangible Property - Marketing Intangible, Wholesale, subsection (d)(2)(A)3. Cartoon Corp enters into a license agreement with Wholesale Corp where Wholesale Corp is granted the right to use Cartoon Corp's cartoon characters in the design and manufacture of tee shirts and sweatshirts which will be sold to various retailers who will in turn sell them to members of the public. Cartoon Corp is unable to develop information regarding the location of the ultimate customer of the products designed and manufactured in connection with Cartoon Corp's cartoon characters. Cartoon Corp shall assign the licensing fee by multiplying the fee by the percentage of this state's population over the total population in the geographic area in which Cartoon Corp markets its goods, services or other items.

42. Subsection (d)(2)(D)5 is an example of the second cascading rule of reasonable approximation for assignment of a sale of a non-marketing or manufacturing intangible property. The previous draft did not contain an example for reasonable approximation in connection with assignment of the sale of non-marketing or manufacturing intangibles, and as stated above, it is the intent to provide an example to show how each rule in this regulation works.

5. Intangible Property - Non-marketing or Manufacturing Intangible, subsection (d)(2)(B)2. Mechanical Corp enters into a license agreement with Spa Corp where Spa Corp is granted the right to use the patents owned by Mechanical Corp to manufacture mechanically operated spa covers for spas that Spa Corp manufactures. Neither the terms of the contract nor the taxpayer's books and records indicate the extent of the use of the patent in this state. However, there is public information that Spa Corp has 3 manufacturing locations in this state and an additional 6 manufacturing locations in various other states.

Mechanical Corp may reasonably approximate the location of the use of the intangible property and assign 33% of the licensing fees to this state.

43. Subsection (d)(2)(D)6 is an example of the third cascading rule of the customer's billing address for assignment of a sale of a non-marketing or manufacturing intangible. The previous draft did not contain an example for customer's billing address, and as stated above, it is the intent to provide an example to show how each rule in this regulation works.

6. Intangible Property - Non-marketing and Manufacturing Intangible, subsection (d)(2)(B)3. Same facts as Example 5 except that Spa Corp is a small, privately held manufacturing corporation that has no publicly available information as to its manufacturing locations, Mechanical Corp shall assign all of the licensing fees to this state if Spa Corp's billing address is in this state.

44. Subsections (d)(2)(D)7 and 8 provide examples of how the two cascading rules for mixed intangibles work. Inadvertently, the facts of the two examples originally appeared in reverse order for application of the cascading rules. The examples' facts have been modified so that they appear in the same order as the cascading rules for mixed intangibles. Thus subsection (d)(2)(D)7's facts refer to where there is a separate and reasonable statement of fees and how the sale would be assigned under those facts, and subsection (d)(2)(D)8's facts refer to where there is no separate statement of fees and how the sale would be assignment under those facts.

~~4~~7. Intangible Property – Mixed Intangible, subsection (d)(2)(C)1. ~~Mixed intangible~~. Axel Corp enters into a two-year license agreement with Biker Corp in which Biker Corp is granted the right to produce motor scooters using patented technology owned by Axel Corp, and also to sell such scooters by marketing the fact that the scooters were manufactured using the special technology. The scooters are manufactured outside this state, but the taxpayer is granted the right to sell the scooters in a geographic area in which this state's population constitutes 25% of the total population in the geographic area during the period in question. The license agreement specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non-marketing intangible. Assuming that the separately stated fees are reasonable, the Franchise Tax Board will: (1) attribute no part of the licensing fee paid for the non-marketing intangible to this state, and (2) attribute 25% of the licensing fee paid for the marketing intangible, to this state. ~~The licensing agreement requires an upfront licensing fee to be paid by Biker Corp to Axel Corp but does not specify which percentage of the fee is derived from Biker Corp's right to use Axel Corp's patented technology. Unless either the taxpayer or the Franchise Tax Board~~

~~reasonably establishes otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible. In such cases, it will be presumed that 25% of the licensing fee constitutes sales in this state.~~

~~5~~8. Intangible Property – Mixed Intangible, subsection (d)(2)(C)2. ~~Mixed intangible.~~ Same facts as Example ~~4~~7, except that ~~the license agreement specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non marketing intangible. Assuming that the separately stated fees are reasonable, the Franchise Tax Board will: (1) attribute no part of the licensing fee paid for the non marketing intangible to this state, and (2) attribute 25% of the licensing fee paid for the marketing intangible to this state. T~~the licensing agreement requires an upfront licensing fee to be paid by Biker Corp to Axel Corp but does not specify which percentage of the fee is derived from Biker Corp's right to use Axel Corp's patented technology. Unless either the taxpayer or the Franchise Tax Board reasonably establishes otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible. In such cases, it will be presumed that 25% of the licensing fee constitutes sales in this state.

45. Subsection (g)(1) provides that the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information to comply with these regulations. The reference is to "assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136." It should reference Revenue and Taxation Code section 25136, subdivision (b), which is the underlying statutory provision for the market-based rules of assigning sales other than sales of tangible personal property. This change has been made.

(1) In assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136(b), the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information, as well as the resources of the taxpayer seeking to obtain this information, and may accept a reasonable approximation when appropriate, such as when the necessary data of a smaller business cannot be reasonably developed from financial records maintained in the regular course of business.

46. Subsection (g)(1)(A) is an example under "Special Rules" to indicate facts when a taxpayer would not be required to alter its recordkeeping method to comply with the provisions of this regulation. A comment at the hearing for this regulation was made that the example gave the impression that only a small corporation would be able to qualify within this provision. As a result, the name of the corporation in the example has been changed to "Misc".

(A) Example. ~~Small~~ Misc Corp, a corporation located in this state, provides limited bookkeeping services to clients both within and outside this state. Some clients have several operations among various states. For the past ten (10) years, ~~Small~~ Misc Corp's only records for the sales of these services have consisted of invoices with the billing address for the client. ~~Small~~ Misc Corp's records have been consistently maintained in this manner. If the FTB determines that ~~Small~~ Misc Corp cannot determine, pursuant to financial records maintained in the regular course of its business, the location where the benefit of the services it performs are received under the rules in this regulation, then ~~Small~~ Misc Corp's sales of services will be assigned to this state using the billing address information maintained by the taxpayer. ~~Small~~ Misc Corp will not be required to alter its recordkeeping method for purposes of this regulation.

47. Subsection (g)(2) lists factors for determination of the location of the use of marketing intangibles. This was moved to the provisions regarding marketing intangibles as subsection (d)(2)(A)2.a. It was determined that this was not a general rule that applied to the entire regulation.

(~~2~~) ~~To determine the customer's or licensee's use of intangible property in this state under subsection (d)(2)(A)2. for use of marketing intangibles, factors that may be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state, or other data including population that reflects the relative usage of the intangible property in this state.~~

48. Subsection (g)(2) is now segue to special rules for reasonable approximation of the location for receipt of the benefit of the services or the location of the use of the intangible property. "[T]he receipt of" was inserted to match the language of the underlying statute and other provisions of this regulation.

(~~3~~2) The following special rules shall apply in determining the method of reasonable approximation of the location for the receipt of the benefit of the services or the location of the use of the intangible property:

49. Subsection (g)(2)(A) provides that once a reasonable approximation method is used, the taxpayer must continue to use that method unless the Franchise Tax Board gives permission for a change to the method. To match the language of the underlying statute and remain consistent with other provisions of this regulation, "receipt of the" was inserted before "benefit of the services." In addition, it has been determined that in fairness to taxpayers, once the Franchise Tax Board has examined the taxpayer's reasonable approximation method and accepted it, the Franchise Tax Board will continue to accept that method until facts and circumstances change such that the method no longer reasonably reflects the market. This is consistent with other provisions of the Revenue and Taxation Code and other Regulations. As a result, language to that effect has been added to this provision.

(A) Once a taxpayer has used a reasonable approximation method to determine the location of the market for the receipt of the benefit of the services or the

location of the use of the intangible property, then the taxpayer must continue to use that method in subsequent taxable years. A change to a different method of reasonable approximation may not be made without the permission of the Franchise Tax Board. Where the Franchise Tax Board has examined the reasonable approximation method and accepted it in writing, the Franchise Tax Board will continue to accept that method, absent any change of material fact such that the method no longer reasonably reflects the market for the receipt of the benefit of the services or the location of the use of the intangible property.

50. Subsection (g)(3)(A) refers to Revenue and Taxation Code section 25136 and Regulation section 25136. "RTC" is changed to "Revenue and Taxation Code". "CCR" is changed to "Regulation" to be consistent with other provisions of this regulation and other regulations. Also, to reflect that the reference is to the market-based rules, it now reads, where appropriate, "Revenue and Taxation Code section 25136, subdivision (a), and Regulation section 25136-2."

(A) All references to ~~RTC~~ Revenue and Taxation Code section and ~~CCR~~ Regulation section 25136 shall refer to ~~RTC~~ Revenue and Taxation Code section 25136(b) and ~~CCR~~ Regulation section 25136-2 as they are operative beginning on and after January 1, 2011.

51. Subsection (g)(3)(C) refers to the incorporation of special industry rules for Franchisors. A comment on this regulation was received that, based on the wording of the subsection, there might be confusion as to whether or not throwout rules apply. To avoid any confusion that throwback or throwout rules apply, language has been inserted indicating that the taxability of a taxpayer in a state is not relevant under the market-based rules. Neither throwback nor throwout rules apply under these market-based rules.

(C) The provisions in Regulation section 25137-3 [Franchisors] that relate to the taxpayer being, or not being, taxable in a state shall not be applicable.

52. Subsection (g)(3)(F) relates to the incorporation of special industry rules for mutual fund providers and specifically refers to assignment of receipts to the location of income-producing activity in the event the taxpayer is not taxable in a state. Those provisions are not applicable to the market-based rules of this regulation and the underlying statute. There is no statutory authority for assignment of a receipt to the location of the income-producing activity if it is not the market state. Therefore, the taxability of a taxpayer in a state which triggers the assignment to the location of the income-producing activity is immaterial and should be eliminated to avoid confusion. At the hearing for this regulation, there was a comment made on that basis.

(F) The provisions in Regulation section 25137-14 that relate to the taxpayer not being taxable in a state and assign the receipts to the location of the income-producing activity that gave rise to the receipts shall not be applicable.

These sufficiently related changes are being made available to the public for the 15 day period required by Government Code section 11346.8, subdivision (c), and California Code of Regulations, title 1, section 44. Written comments regarding these changes will be accepted until 5:00 p.m. on October 24, 2011. The Franchise Tax Board is sending a copy of the proposed amendments to Regulation section 25136 to all individuals who requested notification of such changes, as well as those who commented in writing to the previously noticed proposed amendments to Regulation section 25136.

All inquiries and written comments concerning this notice should be directed to Colleen Berwick at 916-845-3306, FAX 916-845-3648, E-Mail colleen.berwick@ftb.ca.gov; or by mail to the Legal Division, Attn: Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. The notice and the proposed amendments will also be made available at the Franchise Tax Board's website at http://www.ftb.ca.gov/.

TITLE 18. FRANCHISE TAX BOARD
AMENDMENTS TO PROPOSED
REGULATION SECTION 25136, RELATING TO
SALES OF OTHER THAN TANGIBLE PERSONAL PROPERTY

A hearing was held on August 10, 2011 by Melissa Potter of the Franchise Tax Board Legal Division, the "hearing officer," on proposed amendments to California Code of Regulations, title 18, section 25136 (Regulation section 25136), which was noticed in the California Regulatory Notice Register on June 17, 2011. This regulation is intended to provide guidance on assigning sales of other than tangible personal property where a taxpayer makes an election to use the single-sales factor formula and its market-based rules.

Department staff reviewed the proposed regulations and considered the comments submitted before and after the hearing. The hearing officer recommended that certain changes be made which were published in a 15-day notice on October 7, 2011. Nine (9) comments were received during the 15-day comment period. Based on some of the comments received, further 15-day changes are now proposed to be made. A definition has been added for the term, "Complete transfer of all property rights." One modification consists of minor adjustments to the facts in an example. Adjustments for clarification have been made in the provisions for assignment in the case of the sale of stock. There is one change that is proposed by staff, and that is deleting duplicative language in an example.

These nonsubstantial or sufficiently related changes (within the meaning of Govt. Code Section 11346.8) recommended by the hearing officer are reflected in the attachment hereto. These amendments to the regulation are reflected by underscore for additions and strikeout for deletions. Proposed changes to Regulation section 25136 are summarized below.

1. A definition for "Complete transfer of all property rights" has been added under the "General Definitions" section. Hence the numbering of the definitions in the Definitions subsection has changed. For example, "Complete transfer of all property rights" is now (b)(3) and "Intangible property" is now (b)(4) and so on. This numbering change is indicated by strikeout or underscore of the number or letter being removed and/or being added. The subsections referred to in these paragraphs refer to the newly assigned number or letter as assigned by this 15 day notice's proposed changes.

2. Subsection (b)(3) is now the definition for the term, "complete transfer of all property rights." This definition makes it clear that "complete transfer" means a transfer in connection with ownership rights of stock or an interest in a pass-through entity as distinguished from those rights transferred under a license. It is also made clear that "complete transfer" does not mean that a taxpayer's disposition of stock in a corporation or interest in a pass-through entity must be a transfer of 100% of its ownership interest in that entity in order to have its sale assigned under subsections (d)(1)(A)1.a and b.

> <u>(3) "Complete transfer of all property rights" means a transfer of all property rights associated with the ownership of intangible property, as distinguished from</u>

a licensing of intangible property where the licensor retains some ownership rights in connection with the intangible property licensed to a buyer. A complete transfer does not require that a seller has sold all of its stock in a corporation or all of its interest in a pass-through entity; rather, it merely means that the seller retains no property rights in the stock or other interest that has been sold. For example, a seller who owns one hundred (100) percent of the stock of a corporation and sells sixty (60) percent of its ownership interest in corporation retaining no property rights in the stock sold, has engaged in a complete transfer of all property rights with regard to the 60% of the stock that was sold. The sixty (60) percent ownership interest sold is subject to assignment under subsections (d)(1)(A)1.a and b.

3. Subsection (c)(1)(C)1 provides an example of a sale or services to individuals. Language has been added to describe "net plant facilities." Language has also been added to indicate how the property is valued. The last sentence was deleted as confusing and unnecessary.

1. Benefit of the Service – Individuals, subsection (c)(1)(A). Phone Corp provides interstate communications and wireless services to individuals in this state and other states for a monthly fee. The vast majority of consumers of mobile services receive the benefit of the services at many locations. As a result, a customer's billing address is not reflective of the location where the benefit of the services is received by the customer. Phone Corp has operating equipment and facilities used to provide communications services ("net plant facilities") located in geographical areas where customers utilize its services, based on market size and demand. Phone Corp's books and records, kept in the normal course of the business, identify the net plant facilities used in providing the communications services to Phone Corp's customers. Because Phone Corp's books and records show where the benefit of the services is actually received, the presumption of billing address is overcome. Receipts from interstate communications and wireless services will be attributable to this state based upon the ratio of California net plant facilities over total net plant facilities used to provide those services using a consistent methodology of valuing the property, for example, net book basis of the assets that is determined from Phone Corp's books and records. ~~Revenues from interstate and international calls will be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call.~~

4. Subsection (c)(2)(E)6 is an example for sales of services to a business entities. The phrase "or reasonably approximating" has been deleted because it is duplicative of the sentence below it and would potentially create confusion.

6. Benefit of the Service – Business Entity, subsection (c)(2)(C). For a flat fee, Painting Corp contracts with Western Corp to paint Western Corp's various sized, shaped and surfaced buildings located in this state and four (4) other states. The contract does not break down the cost of the painting per building or per state. Painting Corp's books and records kept in the normal course of business indicate the location of the

buildings that are to be painted but do not provide any method for determining ~~or reasonably approximating~~ the extent that the benefit of the service is received in this state, i.e. the size, shape, or surface of each building, or the materials used for each building~~s~~ to be painted. In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received. Since neither the contract nor Painting Corp's books and records indicate how much of the fee is attributable to this state and there is no method of reasonably approximating the location of where the benefit of the service is received, the sale will be assigned to this state if the order for the service was placed from this state.

5. Subsection (d)(1) is the segue for assignment of sales of intangible property where there has been a complete transfer of property rights. It has been modified to reference the definition of "complete transfer of all property rights" in subsection (b)(3).

(1) In the case of the complete transfer of all property rights (as defined in subsection (b)(3)) in intangible property (as defined in subsection (b)(~~3~~4)) for a jurisdiction or jurisdictions, the location of the use of the intangible property shall be determined as follows:

6. Subsection (d)(1) (A)1 provides the segue for the rules of assignment in connection with the sale of stock. To make it clearer that a seller need not own one hundred percent of the stock of an entity, nor sell all one hundred percent of its interest in order for the assignment rules of (d)(1)(A)1 to apply, the words "shares of" have been inserted in front of "stock." Also, in order to reflect the language of the statute, 25136(b)(2), which states that sales of marketable securities are in this state if the purchaser is in this state, the section is amended to add the phrase "other than sales of marketable securities".

1. Where the sale of intangible property is the sale of shares of stock in a corporation or the sale of an ownership interest in a pass-through entity, other than sales of marketable securities, the following rules apply:

7. Subsection (d)(1)(A)1.a. provides the assignment method where 50% or more of the underlying assets of the corporation or pass-through entity sold consist of real and/or tangible personal property. To make it clear that the determination of whether the underlying assets consist of 50% or more of real and/or tangible personal property is to be made on the date of the sale, the language "on the date of the sale" has been inserted after the word "determined." Also, to address the issue of a sale where the stock or interest is sold more than six months after the beginning of the taxable year, a sentence has been added that provides that if the interest is sold more than six (6) months into the current taxable year, then the average of the current taxable year's payroll and property factors shall be used. This provision has been added to address concerns that the earlier language, which provided that the taxpayer must refer back to the last twelve (12) month full tax period, would be, in some cases, looking back almost two (2) years prior to the sale and therefore too far back in connection with the sale in order to have an accurate view of the factors that existed at the time of the sale.

a. In the event that fifty (50) % or more of the amount of the assets of the corporation or pass-through entity sold, determined on the date of the sale and using the original cost basis of those assets, consist of real and/or tangible personal property, the sale of the stock or ownership interest will be assigned by averaging the payroll and property factors of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records kept in the normal course of business. If, however, the sale occurs more than six (6) months into the current taxable year, then the average of the current taxable year's payroll and property factors shall be used.

8. Subsection (d)(1)(A)1.b. provides the rules of assignment of stock where more than 50% of the underlying assets of the corporation or pass-through entity sold consist of intangible property. For the same reasons stated above in paragraph 7, the same changes have been made here.

b. In the event that more than fifty (50) % of the amount of the assets of the corporation or pass-through entity sold, determined on the date of the sale and using the original costs basis of those assets, consist of intangible property, the sale of the stock or ownership interest will be assigned by using the sales factor of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records. If, however, the sale occurs more than six (6) months into the current taxable year, then the current taxable year's sales factor shall be used.

These sufficiently related changes are being made available to the public for the 15 day period required by Government Code section 11346.8, subdivision (c), and California Code of Regulations, title 1, section 44. Written comments regarding these changes will be accepted until 5:00 pm on November 14, 2011. The Franchise Tax Board is sending a copy of the proposed amendments to Regulation 25136 to all individuals who requested notification of such changes, as well as those who commented in writing to the previously noticed proposed amendments to Regulation 25136.

All inquiries and written comments concerning this notice should be directed to Melissa Potter 916-845-7831, FAX 916-843-2114, E-Mail Melissa.potter@ftb.ca.gov or Colleen Berwick at 916-845-3306, FAX 916-845-3648, E-Mail colleen.berwick@ftb.ca.gov; or by mail to the Legal Division, Attn: Melissa Potter or Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. The notice and the proposed amendments will also be made available at the Franchise Tax Board's website at http://www.ftb.ca.gov/.

STAFF SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS
IN CONJUNCTION WITH PUBLIC HEARING ON CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 25136, ON AUGUST 10, 2011

A. WRITTEN AND ORAL COMMENTS FROM SUTHERLAND DATED AUGUST 10, 2011 (SEE TRANSCRIPT, PAGES 5 AND 6)

1. Renumber and Clarify the Scope of Proposed Regulation 25136(b)

This regulation could more clearly state that it is applicable only to those taxpayers making the single sales factor election and employing the corresponding market-based rules of this regulation.

Sutherland, among other commentators, also suggests that the regulation be renumbered to Regulation 25136-2 from the current proposed number 25136(b).

Response:

Both California Revenue and Taxation Code (RTC) section 25136(b) and subsection (a) of this regulation clearly indicate that this regulation that this regulation only applies to those taxpayers who make the single-sales factor election.

Regarding the comment that the regulation be renumbered, please refer to the 15-day notice and accompanying text changes.

Recommendation:

No change to the regulation is necessary.

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2. Clarify References to "In This State"

The reference "in this state" is unclear and subject to varying interpretations. In an example for the definition of "received benefit of a service," it could refer to State A or California. The commentator recommends replacing "in this state" with "California."

Response:

Historically, the RTC and other California regulations refer to California as "this state." In fact, the underlying statute refers to California as "this state." To be consistent with the wording of the underlying statute, other Revenue and Taxation Code sections and other regulation sections, the term "this state" must be the reference to California in the regulation here.

Recommendation:

No change to the regulation is necessary.

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3. Clarify the Meaning of "Cannot be Determined"

Subsection (b)(3) defines the phrase "cannot be determined" to mean "that the taxpayer's records or the records of the taxpayer's customer which are available to the taxpayer do not indicate the location where the benefit of the service was received or where the intangible property was used."

The definition should be amended to state "that the taxpayer's records or the records of the taxpayer's customer that the taxpayer has in its possession or has a right to possess pursuant to a contract with its customer ~~which are available to the taxpayer~~ do not indicate the location of where the benefit of the service was received or where the intangible property was used." The rationale is that taxpayers should not be required to pursue documentation that they do not have a legal right to possess in order to support their tax filing position.

Response:

There is nothing in the subsection referred to here or in any other subsection in this proposed regulatory language that requires taxpayers to pursue documentation to which they do not have access. The taxpayer may have access to its customer's documentation by way of a contractual right, voluntary submission by the taxpayer's customer, public record, or by law. The key is that the taxpayer has access to the documentation; the means of the access is irrelevant. The commentator's suggested alternative language is in fact restrictive because it only allows for access to customer documentation by contractual right and does not acknowledge that a taxpayer may have other means of access to its customer's information. By the explicit terms of this regulation, if a taxpayer does not have access to a customer's information, then that taxpayer does not have the information and the taxpayer may reasonably approximate the location where the benefit of the service was received or where the intangible property was used.

Recommendation:

No change to the regulation necessary.

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4. Create a Safe Harbor for Taxpayers Opting to Rely Upon a Contract Between the Taxpayer and its Customer or the Taxpayer's Books and Records When Sourcing Receipts from Services Provided to Corporations and Other Business Entities

Subsection (c)(2)(A) provides the first cascading rule for assignment of sales of services to business entities and states that the contract between the taxpayer and its customer or the taxpayer's books and records will be presumed to indicate the location where the benefit of the services was received. The commentator suggests that only the taxpayer and not the Franchise Tax Board have the right to overcome the presumption; in other words, the taxpayer be provided a safe harbor rule if the taxpayer chooses the first cascading rule. The rationale for this request is that it will avoid potential disputes with the Franchise Tax Board's audit staff and extensive requests for information regarding each customer.

Response:

Providing a safe harbor rule for taxpayers who have business entity customers would eliminate the Franchise Tax Board's ability to audit what is likely to be a complex question of fact with potentially large effects on the apportionment factor of the taxpayer . The rationale for the Franchise Tax Board's safe harbor provision for sales of services to individuals, subsection (c)(1)(A), is that sales to individuals might not justify an extensive audit because amounts received by any one individual would most likely be immaterial and it is highly likely that the billing address of the individual would correspond with the location of the benefit of the service. This rationale does not apply to sales of services to business entities where the amount of sales could very likely involve large amounts and the benefit of the service is likely a more complex factual inquiry. Sound tax policy requires that tax laws should be fairly, reasonably and consistently applied. In its role as administrator, the Franchise Tax Board has the duty to audit and request information regarding a taxpayer's filing position, ensuring a taxpayer's substantial compliance with the law.

The fact that there will be potential disputes between a taxpayer and the Franchise Tax Board's Audit Division is not a valid reason to eliminate the Franchise Tax Board's duty to audit a taxpayer's filing position. There will be, as there always have been, disagreements between the Audit Division and taxpayers. Taxpayers have the right to dispute the Franchise Tax Board's auditor's findings and file a protest, a claim for refund, an appeal, or pursue litigation in California Superior Court. The right to audit accompanied by the right to dispute an assessment are part of the balance and check system of any good tax policy and its programs.

Recommendation:

No change to the regulation is necessary.

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5. Clarify the Example Contained in Proposed Regulation 25136(b), Subsection (c)(2)(E)4.

The example provides that Web Corp's advertising revenues are to be sourced to the viewers of the advertisements (either using its books and records or by reasonable approximation). The revenues should be sourced to where the customer receives the benefit of the service. Where the customer is a multistate business and receives the benefit of the service in many locations, taxpayers should be able to source receipts either to the state where the benefit is primarily received or to the customer's primary place of business. Also, it would be administratively impracticable for taxpayers to comply with the approach set forth in the example because even if taxpayer's had the information on viewers in its books and records, gathering that information for tax purposes would be burdensome and time consuming.

Response:

The example indicates that the benefit of the advertising services is received where the viewers are located. The underlying statute provides that the benefit of the service shall be assigned to California *to the extent* that the benefit of the service is received in California. What the commentator suggests is to assign the receipts to the primary state or primary place of business, an all or nothing rule. This is in direct contradiction to the terms of the underlying statute which assigns sales of services based on where the benefit of those services is received and not based on where the benefit of the services is "primarily" received.

Regarding the commentator's second point, the particular industry in this example generally keeps track of where viewers of advertisements are located, as it is part of the information and service that the industry offers to the advertisers, forming in large part, the basis for placement of advertisements. It, therefore, will not generally be unduly burdensome or time consuming for taxpayers to comply with assignment rules for sales of services according to where the viewers are located. Furthermore, California is not the only state utilizing a market-based method for the assignment of sales of services. Taxpayers will have to compile the same information in order to file their tax returns in other market-based states. However, in the event that it is burdensome for a taxpayer to assign its sales using this methodology, the taxpayer may be able to avail itself of the provisions of subsection (g)(1) whereby the Franchise Tax Board will consider the "effort and expense required to obtain this information, and may accept a reasonable approximation when appropriate, such as when the necessary date of a smaller business cannot be reasonably developed from financial records maintained in the regular course of business."

Recommendation:

No change in this regulation is necessary.

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6. Clarify the Example Contained in Proposed Regulation 25136(a), Subsection (c)(2)(E)5.

The example indicates that in fact the taxpayer would have a method to reasonably approximate where the benefit of the service was received and that would be through payroll and material costs. The commentator wants other facts for examples of the last two cascading rules.

Response:

Please refer to the 15-day notice and the accompanying text. Additional facts were inserted for clarity. The example works as it is intended to, providing enough facts to indicate that the taxpayer cannot assign the sale of services under the first two cascading rules.

Recommendation:

No change in this regulation is necessary.

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7. Create a Safe Harbor for Taxpayers Opting to Rely Upon a Contract with its Customer or Books and Records When Sourcing the Complete Transfer of Property.

Subsection (d)(1)(A) provides the first cascading rule for assignment of sales of intangible property where there has been a complete transfer of rights. It states that the contract between the taxpayer and its customer or the taxpayer's books and records will be presumed to indicate the location where the benefit of the services was received. The commentator suggests that only the taxpayer and not the Franchise Tax Board have the right to overcome the presumption. In other words, the commentator requests that the taxpayer be provided a safe harbor rule if the taxpayer chooses the first cascading rule, the Franchise Tax Board's "preferred method." The rationale for this request is that it will avoid potential disputes with Franchise Tax Board's audit staff and extensive requests for information regarding each customer.

Response:

Please refer to the Response to Comment 4 by the same commentator.

Recommendation:

No change to this regulation is necessary.

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8. Amend the Rules for Sourcing Receipts from the License, Leasing, Rental or Other Use of Intangible Property

Subsection (d)(2)(A)1 for marketing intangibles is repetitive in its phraseology and is thus confusing. The commentator also suggests a safe harbor rule here too.

Response:

Please refer to the 15-day notice and accompanying text changes mailed and posted October 7, 2011. However, regarding the request for a safe harbor rule here, please refer to the Response to Comment 4 by the same commentator.

Recommendation:

No change to this regulation is necessary.

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9. Amend the Definition of "Reasonable Approximation"

The various provisions regarding reasonable approximation appear in various subsections and should appear only in the definition of "reasonable approximation." Second, the objective of final customer of the marketing intangibles provisions should be made clearer.

Response:

Please refer to the 15-day notice and accompanying text changes mailed and posted October 7, 2011.

Recommendation:

No change to this regulation is necessary.

B. WRITTEN AND ORAL COMMENTS JEFFREY VESELY WITH PILLSBURY, WINTHROP, SHAW, PITMAN (SEE TRANSCRIPT – PAGE 8)

1. In connection with subsection (d)(1) and its example for assignment of a sale of stock or interest in a pass-through entity where the underlying assets of the corporation or pass-through entity consist of 50% or more tangible personal property and/or real property, the concept of this example should also be a provision in the regulation itself. Furthermore, there should be a separate provision for when the underlying assets of the corporation or pass-through entity consist of more than 50% intangible personal property. In that case,

assignment should be made based on RTC section 25125's provision for the sale of a partnership interest using the sales factor. It is also suggested that there be a provision addressing the situation where the underlying assets consist of both tangible personal property and/or real property and intangible property. Finally, the commentator suggests that the full tax period prior to the sale be the period for which the property and payroll factors (for tangible personal property and/or real property) are averaged and for which the sales factor (intangible property) should be used to determine the assignment.

Response:

Please refer to the 15-day notice and accompanying text changes mailed and posted on October 7, 2011 in connection with the concept of the example in subsection (d)(1) set out as a separate substantive provision of the regulation in subsection (d)(1)(A)1 and the addition of a separate provision for the sale of stock of a corporation or interest in pass-through entity in the event the underlying assets of the corporation or pass-through entity constitute more than 50% of intangible property. The two rules, however, are intended to be mutually exclusive. If 50% or more of the underlying assets of the corporation or pass-through entity are tangible personal and/or real property, then the payroll and property factors of the corporation or pass-through entity shall be averaged. If more than 50% of the underlying assets of the corporation or underlying entity consist of intangible property, then the sales factor of the corporation or pass-through entity shall be used. To provide another rule allowing for some sort of combination of the two provisions would be to overly complicate the assignment mechanism. This suggestion was not incorporated into the sale of stock of a corporation or interest in a pass-through entity provisions.

Recommendation:

No change to this regulation is necessary.

C. WRITTEN COMMENTS FROM DAN KOSTENBAUDER WITH HEWLETT PACKARD DATED AUGUST 10, 2011

1. Section (b)(7) refers to population. The source for determining population should be clarified. U.S. census data might be appropriate.

Response:

Please refer to the 15-day notice and accompanying text changes mailed and posted October 7, 2011.

Recommendation:

No change to this regulation is necessary.

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2. Section (g)(1) refers to a small business. Large businesses might also have challenges to develop necessary data.

Response:

Please refer to the 15-day notice and accompanying text changes mailed and posted October 7, 2011.

Recommendation:

No change to this regulation is necessary.

D. ORAL COMMENTS RECEIVED AT THE REGULATORY HEARING AUGUST 10, 2011

1. Hearing Transcript – Page 7. Comment from Delia Besio representing Franklin Resources:

With respect to subsection (g)(4)(E) and the incorporation of Regulation section 25137-14 for mutual fund providers, it appears that the language that relates to throwback in Regulation section 25137-14 should not be applicable.

Response:

Please refer to the 15-day notice and accompanying text changes mailed and posted October 7, 2011.

Recommendation:

No change to this regulation is necessary.

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1. Hearing Transcript – Page 7. Comment from Loren Engquist with Health Net:

In connection with (c)(1)(A), the first cascading rule for benefit of the services to individuals, there is language "where the service is performed" instead of "where the benefit is received." The latter and not the former phrase better reflects the underlying statute.

Response:

Please refer to the 15-day notice and accompanying text changes mailed and posted October 7, 2011.

Recommendation:

No change to this regulation is necessary.

STAFF SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS
IN CONJUNCTION WITH FIRST 15-DAY NOTICE ON CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 25136, MAILED AND POSTED ON OCTOBER 7, 2011

A. WRITTEN COMMENTS RECEIVED FROM BARRY WEISSMAN WITH CHEVRON ON OCTOBER 18, 2011

1. The example in subsection 25136-2(c)(1)(C)1 is unclear in that "net plant facilities" is not defined.

Although the 15-day notice describing the change in this example indicates that for the telecommunications industry the market might be better reflected by the net plant method of assigning sales consistent with FTB's Multistate Audit Technique Manual section 7805, to the casual reader of the regulation, that fact would not be readily apparent. In addition, "net plant facilities" is a new concept and the term "value" is not defined.

Response:

Please refer to the second 15-day notice and accompanying changes mailed and posted on October 26 and 27, 2011, respectively. The concept of "net plant facilities" has existed since 1986.

Recommendation:

No change to this regulation is necessary.

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2. In connection with subsection 25136-2(d)(1)(A)1 and the sale of stock, it is unclear as to whether the "complete transfer" refers to the rights in the stock or an taxpayer's entire interest in an entity

The accompanying example in subsection (d)(1)(D)1 indicates that the taxpayer sells 100% of its interest in a subsidiary which adds to the confusion.

Response:

Please refer to the second 15-day notice and accompanying changes mailed and posted on October 26 and 27, 2011, respectively.

Recommendation:

No change to this regulation is necessary.

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3. In connection with subsection 25136-2(d)(1)(A)1 and the sale of stock, it is unclear what date the assets of the corporation are to be valued in order to determine the 50% threshold of real and tangible personal property or intangible property and what assets are to be considered in that valuation process and how the assets are to be valued.

Commentator also suggests that the first rule in connection with real and tangible personal property be a general or default rule and the second rule be the exception in order to avoid disputes between taxpayers and FTB auditors as to which rule (the real and tangible personal property rule or the intangible property rule) applies.

Response:

Regarding the date the assets are to be valued in order to determine the 50% threshold of either tangible or intangible property, please refer to the second 15-day notice and accompanying changes.

Regarding the type of assets that are to be considered, that will have to be determined on a case by case basis. It is impossible to indicate every possible asset and how each asset would be valued in regulatory language. This is consistent with other provisions in this regulation and other regulations.

Recommendation:

No change to this regulation is necessary.

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4. In connection with subsection 25136-2(d)(1)(A)1, the requirement that the factors be from the most recent 12 month taxable year seems inconsistent with the underlying premise of the regulation.

By using the most recent 12 month taxable year would in some cases be using factors 23 months before the sale took place and not representative of what existed at the time of the sale.

Response:

Please refer to the second 15-day notice and accompanying changes. In order for there to be a representation of the factors over a sufficient period of time, a compromise was attempted to be struck, so that if the sale occurred more than 6 months into the current tax period, then the factors from those 7or more months are to be used and averaged. If, however, the sale occurred less than 7 months into the current tax period, the factors of the most recent 12 month taxable year are to be used and averaged.

Recommendation:

No change to this regulation is necessary.

B. WRITTEN COMMENTS RECEIVED FROM KYLA CHRISTOPHERSON WITH AT&T ON OCTOBER 24, 2011

1. In connection with the example in subsection 25136-2(c)(1)(C)1, additional explanation of "net plant" is provided along with clarification regarding available information in the form of books and records is needed.

The 15-day notice containing the changes to this example refers to the Franchise Tax Board Multistate Audit Technical Manual (MATM) section 7805 but the language in the example does not explain what "net plant" is. Furthermore, the example needs to be more universally applicable to various taxpayers and require a consistent methodology.

Response:

Please refer to the second 15-day notice and accompanying changes mailed and posted on October 26 and 27, 2011, respectively.

Recommendation:

No change to this regulation is necessary.

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2. In connection with the example in subsection 25136-2(c)(1)(C)1, the last sentence is unnecessary and in fact could be interpreted as providing a substantively different rule.

The commentator requests that the last sentence be deleted.

Response:

Please refer to the second 15-day notice and accompanying changes mailed and posted October 26 and 27, 2011 respectively.

Recommendation:

No change to this regulation is necessary.

C. WRITTEN COMMENTS RECEIVED FROM SUTHERLAND ON OCTOBER 24, 2011

1. Clarify how taxpayers overcome the billing address presumption and how taxpayers may reasonably approximate where the benefit of the services is received.

The commentator believes the regulation is confusing as to whether the billing address presumption is overcome based on factors other than the taxpayer's contract or books and records or if the presumption is overcome based only on the taxpayer's contract or books and records.

Response:

The regulation language is clear on its face. To overcome the presumption that the billing address is not the actual location where the benefit of the services was received, the regulation language is clear that the taxpayer must use its contract with its customers or its books and records to do so. The regulation language is also clear that if the taxpayer's contract or its books and records, while indicating that the billing address is not where the benefit of the service is received by the customer, do not provide a method of determining the actual location of where the benefit of the services was received, then the taxpayer may reasonably approximate the location where the benefit of the services are received.

Recommendation:

No change to this regulation is necessary.

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2. Revise the example contained in subsection 25136-2(c)(1)(C) to clarify that the taxpayer is entitled to the billing address safe harbor presumption.

The regulation language that the taxpayer is entitled to the safe harbor presumption of the billing address does not appear in the example itself.

Response:

Examples are not designed to repeat the regulatory language, but rather merely to show how a regulation works. The example is clear on its face that the billing address presumption applies and that the taxpayer through its books and records is able overcome that presumption and provide an alternate method.

Recommendation:

No change to this regulation is necessary.

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3. Make a safe harbor rule for sales of services to business entities and sales and licensing of intangible property.

The same reasoning for providing a safe harbor rule for sales of services to individuals should also apply to sales of services to business entities. Otherwise there will be extensive disputes with FTB audit staff.

Response:

This response has been previously provided in reply to the identical comment made by the same commentator during the 45-day notice period. For the reader's convenience, the response is repeated here.

Providing a safe harbor rule for taxpayers for every provision would eliminate the Franchise Tax Board's ability to audit what is likely to be a complex question of fact with potentially large effects on the apportionment factor of the taxpayer. The rationale for the Franchise Tax Board's safe harbor provision for sales of services to individuals, subsection (c)(1)(A), is that sales to individuals might not justify an extensive audit because amounts received by any one individual would most likely be immaterial and it is highly likely that the billing address of the individual would correspond with the location of the benefit of the service. This rationale does not apply to sales of services to business entities where the amount of sales could very likely involve large amounts and the benefit of the service is likely a more complex factual inquiry. Sound tax policy requires that tax laws should be fairly, reasonably and consistently applied. In its role as administrator, the Franchise Tax Board has the duty to audit and request information regarding a taxpayer's filing position, ensuring a taxpayer's substantial compliance with the law.

The fact that there will be potential disputes between a taxpayer and the Franchise Tax Board's Audit Department is not a valid reason to eliminate the Franchise Tax Board's duty to audit a taxpayer's filing position. There will be, as there always have been, disagreements between the Audit Department and taxpayers. Taxpayers have the right to dispute the Franchise Tax Board's auditor's findings and file a protest, a claim for refund, an appeal, or litigation in a California Superior Court. The right to audit accompanied by the right to dispute an assessment are part of the balance and check system of any good tax policy and its programs.

Recommendation:

No change to this regulation is necessary.

STAFF SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS
IN CONJUNCTION WITH SECOND 15-DAY NOTICE ON CALIFORNIA CODE OF REGULATIONS,
TITLE 18, SECTION 25136, MAILED ON OCTOBER 27, 2011

A. WRITTEN COMMENTS RECEIVED FROM SUTHERLAND ON NOVEMBER 14, 2011

1. Clarify the Scope of Sourcing Presumptions.

The commentator states that it is unclear (1) under what circumstances the presumptive sourcing rule will not be applied, and (2) what type of evidence is needed to satisfy the preponderance of the evidence standard. The commentator also states that the telecommunications example does not state the language of the regulation that the "presumption has been overcome."

Response:

The preponderance of evidence standard is a well-established provision in law. It need not be defined in this regulation. In addition, it is impossible to list every fact and circumstance under which a presumption may be overcome. Throughout the regulation, each division of the cascading rules (e.g. sales of services to business entities, sales of intangible property where there has been a complete transfer of property rights, sales of intangible property where there has been a licensing of intangible property etc) provides that the initial cascading rule must be overcome in order for the Franchise Tax Board or the taxpayer to get to the next cascading rule. This approach was crafted in response to a large number of taxpayers and tax practitioners who were concerned that neither side should be able to choose which rule fit best and follow that rule disregarding the others. By providing the rules as a cascading approach, all taxpayers, as well as the staff of the FTB, will follow the same approach in assigning sales. Whether or not the presumption is overcome (the commentator's first point) and how it can be overcome (the commentator's second point) will have to be determined on a case by case basis depending on facts and circumstances. It is impracticable, if not impossible, to list in this regulation all possible situations. A general rule is sufficient and is consistent with RTC sections and other regulations.

In connection with the example, there is no need for the example to restate the language of the regulation. Examples are strictly fact driven. If the example states that the billing address is not reflective of the market, then obviously the taxpayer has overcome the burden of proof in this example. Furthermore, there is no need to describe the evidence and analysis used to overcome the presumption in this example. Indeed, if such analysis were done for every example in every regulation, regulations would be hundreds of pages long and unduly burdensome and ineffective as tools for guidance. This example is consistent with other examples in this regulation and other regulations.

Recommendation:

No change to this regulation is necessary.

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2. Define "Books and Records" and "Customer Contracts"

The commentator states that the regulation should clarify that an invoice is an acceptable record. The commentator also wants clarification that any contract may be considered. Finally, the commentator wants detailed information as to how the contract can be interpreted.

Response:

If the invoice is part of a taxpayer's "books and records", then it is an acceptable record. Because of the millions of possibilities in connection with "books and records", every potential "books and records" item cannot be identified here. "Books and records" depend on the facts and circumstances of each taxpayer's record-keeping system kept in the normal course of its business. This general term is a commonly understood term that has been a widely-accepted premise of both accounting and tax professions for decades. Clarification of this term is not practicable.

Regarding clarification of types of contract, the regulation as it is currently written is clear on its face. There is nothing ambiguous in this word. There are no restrictions as to which type of contract the regulation refers to; as a result, all types of contracts are acceptable. As far as detailed information on contract interpretation, this will have to be done on a case by case basis in connection with well-established case law interpreting contracts. It is impracticable to anticipate and set out every possible interpretation of every possible contract in a regulation context. A general term is sufficient when it applies to many different factual situations and is consistent with the RTC and other regulations.

Recommendation:

No change to this regulation is necessary.

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3. Reconsider the Proposed Rule for the Sourcing of Sales of Stock and Pass-Through Interests

The commentator suggests that the use of the stock or interest is not where the sold entity is doing business, that the rules are impracticable for taxpayers to administer because some taxpayers will not have available to them the required factor information, that the application of the rules will result in double taxation because some states will assign the same sale to the commercial domicile of the underlying entity, and "marketable securities" is not defined.

Response:

The rules contained in the regulation are meant to determine where the intangibles, including stock, are used. Under the provisions for stock, the use of stock is located where the business is conducted, which is reflected by the business's payroll, property, and sales factors in California. This approach is consistent with other provisions of the RTC and other regulations, e.g. RTC section 25125.

While it may be hard to determine the location, e.g. the payroll, property, and sales factors, the rule discussed by the commentator is but the first rule in the assignment scheme. If that rule cannot be applied, the taxpayer may fall through to other sections of the rules, with a final assignment mechanism based on the billing address of the purchaser.

In the context of formulary apportionment, the risk of double taxation is acceptable under numerous state (e.g., *Citicorp v. Franchise Tax Board* (2000) 100 Cal.Rptr.2d 509) and U.S. Supreme Court (e.g., *Moorman Mfg. Co. v. Bair* (1978) 437 U.S. 267) cases. The apportionment formula is a "rough" approximation of the taxpayer's activities; it is not an exact science and every state need not be consistent in its apportionment rules with every other state. In fact, different states will necessarily have different rules regarding their respective apportionment formulas; this fact may result in double taxation but does not invalidate the formula. *Citicorp*, supra, *Moorman*, supra.

"Marketable securities" is a term used in the underlying RTC section 25136(b)(2) which specifically provides that marketable securities are to be assigned to the location of the customer if the customer is located in this state. It is a commonly used term used throughout the accounting and tax professions. It is unnecessary to define the term here.

Recommendation:

No change to this regulation is necessary.

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4. Define the Term "Tangible Personal Property"

The commentator wants a definition based on the case law of sales and use tax.

Response:

"Tangible Personal Property" is a very old, common term and has been repeatedly defined by numerous case law, in both the income and franchise tax context, as well as the sales and use tax context. Here, the income and franchise tax case law would be controlling. A definition is unnecessary in this regulation.

Recommendation:

No change is necessary in the regulation.

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5. Remove References to Sourcing Sales Based on Population

The commentator objects to "population" as a method of reasonable approximation of the location of the market. The commentator states that population would replace a taxpayer's actual facts and circumstances. The commentator suggests, as alternatives, that Regulation section 25137 be invoked and in these circumstances either the cost of performance rules, elimination of the sales factor from the formula, or a new intangible property factor, be considered.

Response:

Population is only considered as one option under reasonable approximation. To even get to reasonable approximation, the taxpayer must *first* look at its *books and records or contract* with its customer and find them lacking in direction for determination of the location of the market. If that fails, then the taxpayer may use reasonable approximation. The use of reasonable approximation after consideration of a taxpayer's books and records clearly is *not* ignoring the taxpayer's actual facts and circumstances. The reasonableness of the approximation will be based on the facts of the particular taxpayer. Clearly, in some cases, the use of population will not be reasonable.

Regulation section 25137 may be invoked if the standard allocation and apportionment formula does not accurately reflect a taxpayer's business activities in California. If that is determined to be the case, then a reasonable alternate formula is warranted. However, Regulation section 25137 may not be invoked to adopt an unreasonable alternative. A "costs of performance" assignment is not a reasonable alternative. If the taxpayer elects the market based single-sales factor apportionment rule (for which these regulations provide guidance), the taxpayer does so *irrevocably*. The effect of allowing a "costs of performance" rule as an alternative under Regulation section 25137 would be to eliminate the "irrevocability" of the election. If a taxpayer wants a "costs of performance" method of assigning sales of other than sales of tangible personal property, then the taxpayer would merely not make the single-sales factor election, thus placing the taxpayer by default into the "costs of performance" method of assigning sales under Regulation section 25136. In addition, the commentator's alternate suggestion of eliminating the sales factor in the single-sales factor formula is also unreasonable. Regulation section 25137 may not be invoked to eliminate the sales factor when that is the only factor in the apportionment formula (such as here in the event of a single-sales factor formula election) to be used to determine income for California tax purposes. A new intangible property factor is for the California legislature to consider; it is beyond the scope of this regulation.

Recommendation:

No change to this regulation is necessary.

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6. Clarify the Term "Reasonable"

The commentator is asking for a definition of "reasonable" in the circumstances of determining whether a statement for mixed intangibles under subsection (d)(2)(C) is reasonable. The rationale is that it would avoid disputes.

Response:

The term "reasonable" is a facts and circumstances test. There is no way to adequately define it for it is impossible to present each and every fact and circumstance that may indicate a "reasonable" separate statement in connection with mixed intangibles under subsection (d)(2)(C).

Recommendation:

No change to this regulation is necessary.

SUTHERLAND

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November 14, 2011

Melissa Potter
Colleen Berwick
Franchise Tax Board, Legal Division
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Re: Comments on Proposed Regulation 25136-2
Market Sourcing Rule for Sales Other than Sales of Tangible Personal Property

Dear Ms. Potter and Ms. Berwick:

We write to offer comments on the most recent version of the Franchise Tax Board's ("FTB") Proposed Regulation 25136-2 ("Proposed Regulation"). We welcome the opportunity to discuss our comments with you.

1. Clarify the Scope of Sourcing Presumptions.

The Proposed Regulation sets forth cascading rules for sourcing specific types of sales. For each type of sale, an initial primary rule creates a rebuttable presumption that may be overcome based on a preponderance of the evidence. It is unclear (1) under what circumstances the presumptive sourcing rule will not be applied, and (2) what type of evidence is needed to satisfy the preponderance of the evidence standard. Without further elaborating on the interplay between the presumptive and secondary sourcing rules, many questions will arise, including:

- Will the standard used to determine whether the presumptive sourcing rule applies vary from the standard set forth in Cal. Rev. & Tax Code § 25137, which permits an alternative apportionment method if the standard allocation and apportionment provisions fail to fairly reflect the extent of the taxpayer's business activity within the state?

- Will the presumption be overcome if the presumptive sourcing rule produces an acceptable result, but there are better methods available (thus forcing taxpayers to use the "best method") for sourcing the receipts?
- What sources of information should/can taxpayers and the FTB use to overcome the presumptive sourcing rule?

Given that these rules rely on a cascading approach, the FTB should clarify how taxpayers or the FTB can move through the cascading rules by overcoming the presumption.

An example provided in the current Proposed Regulation highlights the ambiguity in applying the presumptive and secondary sourcing rules. The example in Proposed Regulation 25136-2(c)(1)(C)1 states that due to the nature of mobile services, the benefit of the service is received at many locations and not necessarily at the customer's billing address. Therefore, the Proposed Regulation uses a ratio of net plant facilities in the state over total net plant facilities for purposes of sourcing the sales of such services. This example does not state that the taxpayer overcame the presumption by providing evidence, the nature of the evidence, or any other information necessary to apply the preponderance of the evidence standard. (Nor does it clarify that the FTB did not have the right to overcome the billing address presumption.) Rather, the example simply suggests that a customer's billing address inherently does not reflect the location of where a customer receives the benefit of the service. Stating that the presumption has been overcome without discussing the evidence or analysis used to reach this determination is of limited value. This example, as well as other examples, should be revised to clearly apply the preponderance of the evidence standard and analyze the facts and evidence presented to overcome the presumption.

2. Define "Books and Records" and "Customer Contracts."

The rules set forth in Proposed Regulation 25136-2 for sourcing sales of services and intangibles refer to a taxpayer's "books and records" and its "contracts" with customers as a basis for sourcing sales. However, the Proposed Regulation does not define these terms. The Proposed Regulation should provide guidance to taxpayers regarding which types of information are acceptable as books and records. For example, the Proposed Regulation should clarify that a taxpayer's invoice is an acceptable record to source sales of services or intangibles.

Further, the Proposed Regulation should be amended to clarify that *any* type of contract, regardless of how memorialized, may be considered. Taxpayers should be allowed to present evidence that a contract existed and evidence of its terms even in the absence of a written agreement. Further, if the taxpayer relies on a written contract with its customer, the Proposed Regulation should indicate in more detail how the contract can be interpreted to determine where the benefit of a service is received or where an intangible is used.

3. Reconsider the Proposed Rule for the Sourcing of Sales of Stock and Pass-Through Interests.

The FTB recently added separate rules for sourcing the sale of shares of stock in a corporation or the sale of an ownership interest in a pass-through entity, with an exception provided for sales of marketable securities. Proposed Regulation 25136-2(d)(1)(A)1. For those sales, taxpayers must look to see whether 50% or more of the assets of the corporation or pass-through entity consist of real and tangible personal property or intangibles at the time of the sale. If 50% or more of the assets of the entity are real or tangible personal property at the time of the sale, the sold entity's payroll and property factors for the most recent 12 month taxable year are averaged and the sale is sourced accordingly – unless the sale occurs more than 6 months into the current taxable year, in which case the average of the current year's payroll and property factors shall be used. Proposed Regulation 25136-2(d)(1)(A)1.a. If 50% or more of the assets consist of intangible property, then the sale of the stock or ownership interest is sourced using the sold entity's sales factor for the most recent 12 month taxable year – unless the sale occurs more than 6 months into the current taxable year, in which case the current year's sales factor shall be used. Proposed Regulation 25136-2(d)(1)(A)1.b.

These sourcing rules are problematic for several reasons, including:

- These rules for sourcing sales of shares of stock in a corporation or an interest in a pass-through entity are inconsistent with Cal. Rev. & Tax Code § 25136(b)(2) which provides: "Sales from intangible property are in this state to the extent the property is ***used*** in this state." (Emphasis added.) The application of the statute to sales of shares of stock in a corporation or an interest in a pass-through entity (other than marketable securities) should lead to such sales being sourced ***to the location where the shares of stock or the pass-through entity interest were being used by the seller.*** Instead, the Proposed Regulation looks through to the sold entity's apportionment factors to capture where the *sold entity* is doing business. This sourcing rule will lead to illogical results that do not reflect the shareholder's or partner's "use" of its interest because the apportionment factors of the *sold* entity do not necessarily capture where the shares of stock or the interest in a pass-through entity are used.

- These rules are impracticable for taxpayers to administer for a number of reasons. The shareholder or partner may not know the sold entity's asset composition (whether mostly real and tangible personal property or intangible property) or its apportionment factors. Without knowledge of the sold entity's apportionment factors, the shareholder or partner will have no way to source the sale under the Proposed Regulation. Additionally, the Proposed Regulation does not address the situation where the corporation or pass-through entity sources its receipts based on a single sales factor and, therefore, has not calculated a property or payroll factor. Adding to the complexity of these rules, the Proposed Regulation looks to

when during the year the sale of stock or the pass-through interest occurs to determine which year's property, payroll, or sales factors a taxpayer must use to source the sale. The designated year's data may be unavailable to the taxpayer.

- The application of these rules to sales of stock in a corporation or an interest in a pass-through entity will likely result in double taxation because while the FTB's Proposed Regulation looks through to the apportionment factors of the sold entity, most states will source the sale to the location of the owner's commercial domicile.

- Lastly, sales of "marketable securities" are specifically excluded from the scope of the rules for sourcing sales of shares of stock in a corporation or an interest in a pass-through entity. The Proposed Regulation does not define the term "marketable securities." The FTB should clarify what it means by marketable securities so that the scope of the rule is clear.

The FTB should provide a rule for sourcing sales of stock in a corporation or an interest in a pass-through entity that captures the location where the taxpayer uses its stock or interest and that is practical to apply – as Cal. Rev. & Tax Code § 25136(b) requires.

4. Define the Term "Tangible Personal Property."

The Proposed Regulation defines "intangible property," however, it does *not* define "tangible personal property." Nor does the Proposed Regulation provide guidance as to when receipts should be sourced using the rules applicable to sales of tangible personal property found in Cal. Rev. & Tax Code § 25135 or those applicable to sales other than sales of tangible personal property found in Cal. Rev. & Tax Code § 25136.

The FTB should also state whether the well-developed body of sales and use tax law that differentiates between tangible and intangible property applies for sales factor purposes. If sales tax principles are applicable, then the FTB should address the application of those principles to software transactions (e.g., custom, canned, electronically delivered) for sales factor sourcing.

5. Remove References to Sourcing Sales Based on Population.

The Proposed Regulation references sourcing sales based on population both in its definition of "reasonable approximation" and its rules for sourcing wholesale sales of marketing intangibles. Any apportionment rule which foregoes a review of a taxpayer's actual facts and circumstances, and replaces it with sourcing based on a state's population is per se invalid. Population-based sourcing does not reflect an attempt to determine where the benefit of a service is received or where intangible property is used. Rather, it is an abdication of a sourcing method.

If a benefit of a service or use of intangible property cannot be determined, then the equitable apportionment provisions contained in Cal. Rev. & Tax Code § 25137 should be invoked. Under this provision, all alternatives should be considered – including using a different

sales factor sourcing rule (such as costs of performance), eliminating the sales factor from the formula and/or employing another factor such as an intangible property factor.

6. Clarify the Term "Reasonable."

When sourcing sales of mixed intangibles, if the taxpayer's licensing contract separately states the amount of fees paid for the marketing and non-marketing intangibles, the FTB will accept such statement if it is "reasonable." Proposed Regulation 25136-2(d)(2)(C)1. It is unclear what the FTB will interpret as "reasonable," and there will be disputes over such a subjective factor. The FTB should clarify its interpretation of "reasonable" in this context.

We appreciate your consideration of our comments.

Sincerely,

P. Mata

Pilar Mata

Michele Pielsticker

cc: Carl Joseph

From: Vesely, Jeffrey M. [mailto:jeffrey.vesely@pillsburylaw.com]
Sent: Thursday, August 04, 2011 6:47 PM
To: Potter.Melissa
Cc: Matsubara, Kerne H. O.; Huang, Annie H.
Subject: Proposed Regulation 25136(b)
Importance: High

Melissa,

We have now had a chance to review your proposed changes. Here are our comments/suggested revisions.

1. We believe deleting old examples 1 and 2 and instead adding the special rules expressed therein in the body as Regulation 25136(d)(1)(A)1.a. and b. is a good idea.

2. The reference to "sale of stock" in the lead-in language of Regulation 25136(d)(1)(A)1 is too narrow. It should be broadened to read "sale of stock of a corporation or of an interest in a pass-through entity."

3. In Regulation 25136(d)(1)(A)1.a., we would suggest that it be revised as follows: " In the event that more than 50 percent of the value of the assets of the corporation or pass-through entity sold consist of real and/or tangible personal property,..."

4. In Regulation 25136(d)(1)(A)1.b., we would suggest that it be revised as follows: "In the event that more than 50 percent of the value of the assets of the corporation or pass-through entity sold consist of intangible property, the receipts from the sale of stock of the corporation or of the interest in the pass-through entity will be assigned to California by using the sales generated by those intangibles in this state for the most recent full tax period preceding the sale, to the extent indicated by the books and records of the corporation or pass-through entity."

5. In Regulation 25136(d)(1)(A)1. a., we would suggest that you insert "most recent" before "full tax period" and substitute "preceding" for "prior to the time of ".

6. In Regulation 25136(d)(1)(A)1., it is unclear as to how the presumption would work in conjunction with the special rules in subdivisions a and b. We would suggest you revise the language as follows: " "Where the sale of intangible property is the sale of stock of a corporation or an interest in a pass-through entity, the presumption under subparagraph (A) shall instead be based on the following rules:"

If you have any questions, please give me a call. Thanks again for the opportunity to provide our comments.

Regards,
Jeff

Jeffrey M. Vesely | Pillsbury Winthrop Shaw Pittman LLP

Tel: 415.983.1075 | Fax: 415.983.1200
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From: Kostenbauder, Dan [dan.kostenbauder@hp.com]
Sent: Wednesday, August 10, 2011 2:06 PM
To: Potter.Melissa; Berwick.Colleen
Subject: Hearing on Aug 10 re sec. 25136

-- Sent from my Palm Pre
Section (b)(7) refers to population. Could you clarify whether we should use last available census data or another source.

Section (g)(1) refers to a small business. Large businesses might also have challenges to develop necessary data. For example, information might not be available in financial systems that the tax department has access to. Extracting information from other business systes might be inordinately expensive.

Thank you for your consideration.

Best regards,
Dan Kostenbauder

Item #3c1-9-4 .txt

STATE OF CALIFORNIA

FRANCHISE TAX BOARD

PUBLIC HEARING

AMENDMENTS TO CALIFORNIA CODE OF REGULATIONS

TITLE 18, SECTION 25136

WEDNESDAY, AUGUST 10, 2011

FRANCHISE TAX BOARD

9496 BUTTERFIELD WAY

TOWN CENTER GOLDEN STATE ROOM A

SACRAMENTO, CALIFORNIA

1:00 P.M.

REPORTED BY: HEATHER PIERCE
CSR No. 13549

CAPITOL REPORTERS -- (916)923-5447

APPEARANCES

HEARING OFFICER:

Melissa Potter

FRANCHISE TAX BOARD STAFF:

Colleen Berwick

PUBLIC COMMENTS:

MICHELLE PIELSTICKER
Sutherland, Absill, & Brennan

DELIA BESIO
Franklin Resources

LORIN ENGQUIST
Health Net

JEFFREY VESELY
Pillsbury, Winthrop, Shaw, Pitman

--o0o--

SACRAMENTO, CALIFORNIA

WEDNESDAY, AUGUST 10, 2011, 1:00 P.M.

--o0o--

THE HEARING OFFICER: Good afternoon everyone. My name is Melissa Potter. I am a tax counsel for the California Franchise Tax Board, and I will be acting as hearing officer for the revisions to California Code of Regulations, Title 18, Section 25136, relating to sales other than tangible personnel property.

As required by the California Administrative Procedures Act, on June 17th, 2011, a notice of this hearing, proposed language, and the initial statement of reasoning supporting the proposed amendments to Regulation Section 25136 were mailed to members of the public as provided by Government Code Section 11346.4.

The notice was also published in the Office of Administrative Law's register proposed rulemaking action -- and I'm going to pause right here. We have additional people coming in.

(Additional attendees enter room.)

THE HEARING OFFICER: In addition, the notice of proposed amendments and the initial statement of reasons appear on the Franchise Tax Board's website, www.ftb.ca.gov, and today I provided these same documents on the table to my right. This hearing is being held

pursuant to Government Code Section 11346.8 to allow the members of the public to submit statements regarding the amendment to Regulation Section 25136.

Oral comments received today as well as those

written comments received since June 17th, 2011, will be considered as part of the full regulatory process. All comments, oral and written, will be considered by the Franchise Tax Board staff and formally addressed by Franchise Tax Board staff in writing.

The name of the document will be Staff Summary Of Comments, Responses, and Recommendations. The summary will be published on the Franchise Tax Board's website. The summary will also be included in the rulemaking files submitted to the Office of Administrative Law as provided by the Administrative Procedures Act.

Anyone who desires to make an oral presentation at this hearing may do so in a few moments. In addition, anyone who desires to submit written comments regarding the revisions to regulations may submit such comments to Colleen Berwick or myself. Comments may be faxed to (916)845-3648 or they may be emailed to Ms. Berwick at Colleen.berwick@ftb.ca.gov; C-O-L-L-E-E-N, dot, B-E-R-W-I-C-K, at ftb.ca.gov; or myself at melissa.potter@ftb.ca.gov; M-E-L-I-S-S-A, dot, potter, P-O-T-T-E-R, at ftb.ca.gov.

All written comments must be submitted by today at 5:00 p.m. All oral comments must be submitted during this hearing.

There is a registrar here to my right that will become part of the record of the hearing. If you haven't done so, we would ask that you sign in. We would also

appreciate it if you would leave your business cards.

To my left is -- my way left -- is a court reporter who is taking down everything we say today. At the end of the hearing, she will prepare a transcript which will become part of the rulemaking file. Because a formal record of the hearing is being made, I ask each of you who desires to make a comment to speak clearly so that the court reporter can accurately record your comments.

Also, when making comments, please identify yourself, spell your name, and identify whom you represent or what firm you're with.

Does anyone wish to make any comments today?

MS. PIELSTICKER: Michelle Pielsticker; Sutherland, Absill, and Brennan. I'm here today to incorporate the written comments by reference, and additionally address a major point.

One, we propose that the regulation be renumbered to clarify that it only applies to those electing single sales factor. We believe that a number of regulations

from 25136(b) as opposed to, say, dash one (-1), creates the impression that it could possibly apply to those electing three factor.

Secondly, proposed regulation 25136(b), subsection (b)(3), defines "cannot be determined" to mean that the taxpayer's records, or the records of the taxpayer's customer, which are available to the taxpayer, do not indicate the location where the benefit of the service was

received or where the intangible property was used.

The phrase "cannot be determined" should be amended to state that the taxpayer's records, or the records of the taxpayer's customer that the taxpayer has in it's possession, or has a right to possession pursuant to a contract with a customer -- excuse me -- do not indicate the location where the benefit of the service was received or where the intangible property was used.

And then, finally, throughout the regulation, there are presumptions established with respect to taxpayers opting to rely upon a contract with it's customer or books and records. We believe that the presumption should create a safe harbor for taxpayers that do opt to rely on the contract or the customer's books or records with the respect to cascading rules so that FTB cannot overcome that presumption and only a taxpayer can overcome the presumption to incent compliance with the cascade.

THE HEARING OFFICER: Thank you.

Ms. Pielsticker, can I have you clarify one point on the safe harbor rule request? Are you requesting that for every presumption that appears in the regulation?

MS. PIELSTICKER: Yes. There is not one presumption with respect to individual taxpayers that creates a safe harbor for taxpayers and allows taxpayers, not the FTB, to overcome the presumption. But with regard to businesses, the presumption can be rebutted by the Franchise Tax Board.

THE HEARING OFFICER: Thank you very much. We will address all your concerns in our summary.

Anyone else?

MS. BESIO: Good afternoon. My name is Delia, D-E-L-I-A; Besio, B-E-S-I-O. I'm with Franklin Resources.

My comment is with respect to subsection (g)(4). It appears that, inadvertently, the minute of modification reference to Regulation Section 25137-14; therefore, we propose to add after Subsection (g)(4)(E) that the provisions in Regulation Section 25137-14, with regard to mutual funds that relate to throwback, shall not be applicable.

Thank you.

THE HEARING OFFICER: Thank you. Again, we will address your concerns in our summary.

Anyone else?

MR. ENGQUIST: My name is Lorin Engquist, L-O-R-I-N, E-N-G-Q-U-I-S-T, with Health Net.

My comment is on subsection (c)(1)(A), under which the taxpayer can overcome a presumption of the building address as being the state in which the benefit is received with evidence of another location.

In the Informative Digest/Plain English Overview, (c)(1)(A) is described as -- it refers to the phrase "where the benefit is received," which I think is reflective of the statute. But in the direct regulations, instead of that phrase, "where the service is performed"

is used. So I believe that the Informative Digest better reflects the statute than the direct regulation.

That's it. Thank you.

THE HEARING OFFICER: Thank you, Mr. Engquist, very much.

Anyone else?

MR. VESELY: I'm Jeffrey Vesely with Pillsbury, Winthrop, Shaw, Pitman. Our comments are directed to Subsection (d) as in David, (1), and then (D), and Example 1.

We believe that this particular provision here is an example that deals with the sale of stock on an entity whose assets are primarily real and tangible personnel

property. We believe that there actually should be the situation addressed where we have an entity whose assets are primarily intangible. And we believe, as well, that instead of doing it in terms of an example under (d)(1), that there actually by a modification to (d)(1)(A) to try to -- excuse me -- or to another provision above that, instead of an example that addresses the situation of if you have a primarily intangible entity.

And we are willing to work with you on some language on this, but that would be our one principle thing. And so thank you.

THE HEARING OFFICER: Thank you.

Anyone else?

(Pause for comments from attendees.)

THE HEARING OFFICER: Okay. I think it's maybe a good guess that we will have to do one more draft that will incorporate some changes, and that would be done with a 15-day notice.

Also, for those of you who have asked for a timeline, we will be going to our premember tax board in the December meeting for final approval of the regulation language. And after that, it will proceed to the Office of Administrative Law for approval, which may take 30 -- or they have 30 working days in order to approve the regulation language. However, no matter when OAL approves

it and it's entered in with the Secretary of State, the regulation will be retroactive to January 1, 2011. So we're moving this along as quickly as we can.

And I want to personally thank everyone that's made comments today, both on and off the record. It's been immensely helpful. I really appreciate everyone's time, energy, and effort in getting this regulation project done.

Thank you so much and have a great afternoon.

(Hearing adjourned.)

--o0o--

REPORTER'S CERTIFICATE

--oOo--

STATE OF CALIFORNIA)
) ss.
COUNTY OF SACRAMENTO)

I, HEATHER L. PIERCE, a Certified Shorthand Reporter in the State of California, sworn and disinterested person, certify:

That I reported verbatim in shorthand writing the named proceedings;

That I thereafter caused my shorthand writing to be reduced to typewriting, and the pages numbered 1 through 10, inclusive, constitute a complete, true, and correct record of said proceedings.

IN WITNESS THEREFORE, I subscribe my name this 23rd day of August, 2011.

HEATHER L. PIERCE
CSR No. 13549

From: CHRISTOFFERSEN, KYLA (Legal) [kc8424@att.com]
Sent: Monday, October 24, 2011 12:21 PM
To: Potter, Melissa@FTB
Cc: Berwick, Colleen@FTB
Subject: AT&T Comment on Proposed Regulation 25136-2
Attachments: Subsection (c)(1)(C)1 example.doc

Dear Melissa,

This email addresses two matters pertaining to the September 25, 2011 draft of Regulation 25136-2:

1) You have requested additional explanation regarding the use of "net plant" in Subsection (c)(1)(C)1. That explanation is provided below.

2) AT&T is requesting that the final sentence be deleted from the Subsection (c)(1)(C)1 example as it may create confusion.

The net plant method is not new. The Multistate Audit Technique Manual has included this language since at least 1986, so it has been in use for several decades and is a familiar concept within the industry. However, in order to provide additional clarification, we have revised the example to include a brief description.

We have also provided additional clarification regarding the valuation of net plant assets. The taxpayer's books and records are used to "reflect the net plant facilities." The nature of the books and records available to identify the net plant assets in sufficient detail to apply the methodology may vary from taxpayer to taxpayer. Therefore, in order to make the example more universally applicable, the example has been revised to require that a consistent methodology be used to value the net plant assets so that the ratio of California net plant assets to total net plant assets is clearly reflected. Using the net book basis for the valuation is provided merely as an example of a consistent methodology.

Finally, AT&T is requesting that the final sentence be deleted from the example. The second to the last sentence describes how the net plant method is used to assign receipts from interstate communications and wireless services. However, the last sentence seems duplicative of that rule, and only applies to a subset of interstate communications (the term in this sentence is "calls," which excludes other types of interstate communications, such as data communications). This last sentence is not necessary and could be interpreted as providing a substantively different rule for these communications. We request that the last sentence be deleted.
Below are our proposed revisions to the example:
(C) Examples.
1. Benefit of the Service - Individuals, subsection (c)(1)(A). Phone Corp provides interstate communications and wireless services to individuals in this state and other states for a monthly fee. The vast majority of consumers of mobile services receive the benefit of the services at many locations. As a result, a customer's billing address is not reflective of the location where the benefit of the services is received by the customer. Phone Corp has operating equipment and facilities used to provide communications services ("net plant facilities") located in geographical areas where customers utilize its services, based on market size and demand. Phone Corp's books and records, kept in the normal course of the business, identify the net plant facilities used in providing the communications services to Phone Corp's customers. Because Phone Corp's books and records show where the benefit of the services is actually received, the presumption of billing address is overcome. Receipts from interstate communications and wireless services will be attributable to this state based upon the ratio of California net plant facilities over total net plant facilities used to provide those services using a consistent methodology of valuing the property, for example, net book basis of the assets

that is determinable from Phone Corp's books and records. Revenues from interstate and international calls will be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call.

Thank you for the opportunity to comment. Please let me know if you have any questions.

Best regards,

Kyla Christoffersen
General Attorney
AT&T Legal-Regulatory & Legislative Affairs
1215 K Street, Suite 1800
Sacramento, CA 95814
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(C) Examples.
1. Benefit of the Service – Individuals, subsection (c)(1)(A). Phone Corp provides interstate communications and wireless services to individuals in this state and other states for a monthly fee. The vast majority of consumers of mobile services receive the benefit of the services at many locations. As a result, a customer's billing address is not reflective of the location where the benefit of the services is received by the customer. Phone Corp has operating equipment and facilities used to provide communications services ("net plant facilities") located in geographical areas where customers utilize its services, based on market size and demand. Phone Corp's books and records, kept in the normal course of the business, identify the net plant facilities used in providing the communications services to Phone Corp's customers. Because Phone Corp's books and records show where the benefit of the services is actually received, the presumption of billing address is overcome. Receipts from interstate communications and wireless services will be attributable to this state based upon the ratio of California net plant facilities over total net plant facilities used to provide those services using a consistent methodology of valuing the property, for example, net book basis of the assets that is determinable from Phone Corp's books and records. Revenues from interstate and international calls will be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call.

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October 24, 2011

Melissa Potter
Colleen Berwick
Franchise Tax Board, Legal Division
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Re: Comments on Proposed Regulation 25136-2
Market Sourcing Rule for Sales Other than Sales of Tangible Personal Property

Dear Ms. Potter and Ms. Berwick:

We write to offer comments on the Franchise Tax Board's ("FTB") Proposed Regulation 25136-2 ("Proposed Regulation"). We welcome the opportunity to discuss our comments with you at any time.

1. Clarify How Taxpayers Can Overcome the Billing Address Presumption and Reasonably Approximate Where the Benefit of the Service Is Received.

Proposed Regulation 25136-2(c)(1)(A) provides a presumption that the billing address of the taxpayer's customer is where the customer receives the benefit of the service. The Proposed Regulation provides that the taxpayer may overcome the presumption by showing, based upon a preponderance of the evidence, "that either the contract between the taxpayer and the taxpayer's customer, or other books and records of the taxpayer kept in the normal course of business, provide the extent to which the benefit of the service is received at a location (or locations) in this state." Proposed Regulation 25136-2(c)(1)(A) further states that the FTB may examine the taxpayer's alternative method to determine "if the billing address presumption has been

overcome, and if so, whether the taxpayer's alternative method of assignment reasonably reflects where the benefit of the service was received by the taxpayer's customers."

Proposed Regulation 25136-2(c)(1)(B) then provides that if the billing address presumption is overcome but "an alternative method cannot be determined by reference to the contract between the taxpayer and its customer or the taxpayer's books and records kept in the normal course of business, then the location where the benefit of the services is received by the customer shall be reasonably approximated."

Proposed Regulation 25136-2(c)(1)(A) should be clarified to address the circumstances under which reasonable approximation will be permitted. As written, Proposed Regulation 25136-2(c)(1)(A) suggests that the billing address presumption can be overcome only if the taxpayer's contracts or books and records address where the benefit of the service will be provided. Yet reasonable approximation will be permitted only if the "an alternative method cannot be determined by reference to the contract between the taxpayer and its customer or the taxpayer's books and records kept in the normal course of business."

The Proposed Regulation should be revised to clarify: (1) whether the billing address presumption can be overcome based upon factors other than the taxpayer's contracts or books and records or (2) whether reasonable approximation will be used only if the taxpayer has contracts or books and records addressing where the benefit of the service will be received but such documents fail to provide accurate reflections of where the benefits were actually received.

2. Revise the Example Contained in Proposed Regulation 25136-2(c)(1)(C).1 to Clarify That the Taxpayer Is Entitled to the Billing Address Presumption.

Proposed Regulation 25136-2(c)(1)(C).1 contains an example for Phone Corp, which states that Phone Corp shall source receipts from sales of interstate communications and wireless services to individuals based on the location of Phone Corp's net plant facilities. The Proposed Regulation notes that "a customer's billing address is not reflective of the location where the benefit of the services is received by the customer" and that "[b]ecause Phone Corp's books and records show where the benefit of the services is actually received, the presumption of the billing address is overcome."

The example should clarify that because Phone Corp is selling services to individuals, Phone Corp is entitled to rely upon the billing address safe harbor contained in Proposed Regulation 25136-2(c)(1)(A) but that, if Phone Corp chooses to reject the billing address presumption, Phone Corp may do so under the described circumstances.

3. Create a Safe Harbor Similar to the One Provided for the Sales of Services to Individuals for the Sales of Services to Businesses and the Sales and Licenses of Intangibles.

During the rule-making process, the FTB inserted a safe harbor for taxpayers sourcing receipts from sales of services to individuals. As noted by the FTB:

> Subsection (c)(1) also provides a safe harbor rule for taxpayers so that if the taxpayer uses the individual customer's billing address as the mechanism for assignment of the sales, then the Franchise Tax Board must accept this presumptively correct assignment. This language was added because comments at the interested parties meetings indicated concern that the Franchise Tax Board's auditors would attempt to overcome the presumption of billing address by looking at individual customers one by one and that, in light of the small amounts of money at stake for any individual customer, this would be overly burdensome for taxpayers.[1]

This reasoning applies equally to sales of services to businesses and sales and licenses of intangibles. Safe harbors allow taxpayers to rely on their sourcing method when done consistent with the preference found in the Proposed Regulation. Without this reliance, taxpayers will potentially be subject to extensive disputes with audit staff even if they have followed the method for sourcing the sales in the Regulation. The FTB should create safe harbors for sales of services to businesses (Proposed Regulation 25136-2(c)(2)(A)), complete sales of intangibles (Proposed Regulation 25136-2(d)(1)(A)) and the licensing of intangibles (Proposed Regulation 25136-2(d)(2)).

We appreciate your consideration of our comments.

Sincerely,

Pilar Mata

Michele Pielsticker

[1] See, Initial Statement of Reasons for the Adoption of California Code of Regulations, title 18, Section 25136, available at: http://www.ftb.ca.gov/law/intParty/ISR_b_final_25136_08102011.pdf, pg. 4-5.

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August 10, 2011

Melissa Potter
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Rancho Cordova, CA 95741-1720

Re: Comments on Proposed Regulation 25136(b)
Market Sourcing Rule for Sales Other than Sales of Tangible Personal Property

Dear Ms. Potter and Ms. Berwick:

We write to offer comments on the Franchise Tax Board's ("FTB") Proposed Regulation 25136(b) ("Proposed Regulation"). We welcome the opportunity to discuss our comments with you at any time.

1. Renumber and Clarify the Scope of Proposed Regulation 25136(b)

Proposed Regulation 25136(b) is intended to apply to taxpayers that have receipts from sales of services and intangibles who elect to apportion their income using a single sales factor apportionment formula. The Proposed Regulation is not intended to apply to taxpayers who elect to continue using California's three factor apportionment formula, who source their receipts using the costs-of-performance method.

It is unclear that the Proposed Regulation is applicable only to those taxpayers making the single sales factor election and employing the corresponding market sourcing rules set forth in Cal. Rev. & Tax Code § 25136(b). We note that the Proposed Regulation was renumbered as Proposed Regulation 25136(b), presumably in an effort to address this concern. However, we

believe that further clarification is needed and that Proposed Regulation 25136(b) may be confused with subsection (b) of existing Regulation 25136. Therefore, we suggest renumbering Proposed Regulation 25136(b) as Regulation 25136-1 and clarifying that the provisions in the Proposed Regulation refer only to Cal. Rev. & Tax. Code § 25136(b).

2. Clarify References to "In This State."

Under Proposed Regulation 25136(b), subsection (a), receipts from sales other than sales of tangible personal property "are in this state if the taxpayer's market for the sales is in this state." Proposed Regulation 25136(b), subsection (b)(1), further states that "benefit of a service is received" means "the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service."

The reference to "in this state" is unclear and subject to varying interpretations. For example, Proposed Regulation 25136(b), subsection (b)(1)(A), states that "Real Estate Development Corp with its commercial domicile in State A is developing a tract of land in this state." Based upon the context, the phrase "in this state" could be deemed to refer to State A or California. This potential confusion could be avoided by replacing "in this state" with "in California."

3. Clarify the Meaning of "Cannot Be Determined."

Proposed Regulation 25136(b), subsection (b)(3), defines the phrase "cannot be determined" to mean "that the taxpayer's records or the records of the taxpayer's customer which are available to the taxpayer do not indicate the location where the benefit of the service was received or where the intangible property was used."

The phrase "cannot be determined" should be amended to state "that the taxpayer's records or the records of the taxpayer's customer that the taxpayer has in its possession or has a right to possess pursuant to a contract with its customer ~~which are available to the taxpayer~~ do not indicate the location where the benefit of the service was received or where the intangible property was used." The purpose of this amendment is to avoid potential disputes with audit staff as to when information is "available to the taxpayer." Taxpayers should not be required to pursue documentation that they do not have a legal right to possess in order to support their tax filing position.

4. Create a Safe Harbor for Taxpayers Opting to Rely Upon a Contract Between the Taxpayer and its Customer or the Taxpayer's Books and Records When Sourcing Receipts from Services Provided to Corporations and Other Business Entities.

Proposed Regulation 25136(b), subsection (c)(2)(A), which identifies the contract between the taxpayer and its customer or the taxpayer's books and records maintained in the

normal course of business as the presumed location of receipts of the benefit of the service, states that "this presumption may be overcome by the taxpayer or the Franchise Tax Board upon an evidentiary showing, by a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received."

This provision should be amended to permit the taxpayer, but not the FTB, to overcome the presumption with alternate evidence. That is, the regulation should provide a safe harbor for taxpayers that choose to use the FTB's preferred method for determining where the benefit of a service is received. The purpose of this amendment is to avoid potential disputes with audit staff and extensive requests for information regarding each customer.

5. Clarify the Example Contained in Proposed Regulation 25136(b), Subsection (c)(2)(E).4.

Proposed Regulation 25136(b), subsection (c)(2)(E).4, provides an example whereby Web Corp provides internet content to its viewers and receives revenue from other businesses that advertise on Web Corp's website ("advertisers"). The example posits that the contracts between Web Corp and its advertisers do not address the location where the benefits are to be received, and that the advertising fees will be determined by reference to the number of times the advertisements are viewed and/or clicked by Web Corp's viewers. The Proposed Regulation suggests that if Web Corp can determine the location of the viewer using its books and records, the advertising receipts should be sourced on this basis; otherwise, Web Corp should reasonably approximate the location of the benefit by determining the ratio of viewers in California versus elsewhere. In other words, the advertising fees are to be sourced based upon the location of Web Corp's viewers rather than on the location of Web Corp's customers (i.e., the advertisers).

As a general rule, receipts for the provision of services should be sourced to the location where the customer receives the benefit of the service. Where the customer is a business with multistate operations, and the services will benefit the customer's business as a whole, taxpayers should be permitted to source receipts to the state where the benefit is primarily received, but have the option to demonstrate that the service benefits the customer in more than one location. Taxpayer's should be entitled to use the customer's primary place of business as a proxy for where the benefit is received.

Moreover, it is not practicable to expect taxpayers to comply with the approach set forth in the example. Assuming *arguendo* that Web Corp *has* information regarding where its viewers are located and can track their activity by advertisement, Web Corp would be required to gather information for each advertisement, and then source the fees associated with that advertisement based on that ratio. This information may exist in Web Corp's books and records, but compiling this information would be unduly burdensome and time consuming. Presenting taxpayers with a

rule that cannot be administered practicably is destined to lead to disputes with audit staff and extensive requests for information regarding each transaction.

6. Clarify the Example Contained in Proposed Regulation 25136(b), Subsection (c)(2)(E).5.

Proposed Regulation 25136(b), subsection (c)(2)(E).5, provides an example whereby Painting Corp paints buildings located in four states. The example posits that the contract does not break down the cost of painting each building, Painting Corp does not have this information in its books and records, and Painting Corp has no means of approximating the extent to which the benefits of services are received in the state. It seems unlikely that Painting Corp would not have a means of reasonably approximating the value attributable to different locations because Painting Corp must use employees and materials to perform the services. An example using other facts should be used to illustrate instances where the state from which the order was placed or where the billing address is located should be used under the cascading rule.

7. Create a Safe Harbor for Taxpayers Opting to Rely Upon a Contract with its Customer or Books and Records When Sourcing the Complete Transfer of Intangible Property.

Proposed Regulation 25136(b), subsection (d)(1)(A), which identifies the contract between the taxpayer and the purchaser or the taxpayer's books and records as the presumed location for where the purchaser will use the intangible at the time of the purchase, states that "[t]his presumption may be overcome by the taxpayer or the Franchise Tax Board by a preponderance of the evidence showing that the purchaser's use of the intangible at the time of the purchase is not consistent with the terms of the contract or the taxpayer's books and records."

This provision should be amended to permit the taxpayer, but <u>not</u> the FTB, to overcome the presumption with alternate evidence. That is, the regulation should provide a safe harbor for taxpayers that choose to use the FTB's preferred method for determining where the use of the intangible will occur. The purpose of this amendment is to avoid potential disputes with audit staff and extensive requests for information regarding each customer.

8. Amend the Rules for Sourcing Receipts from the License, Leasing, Rental or Other Use of Intangible Property.

Proposed Regulation 25136(b), subsection (d)(2)(A).1, initially provides that:

> Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items, the royalties or other licensing fees paid by the licensee for such right(s) are presumed to be attributable to this state to the extent that the fees are attributable

> to the sale or other provision of goods, services, or other items purchased or otherwise acquired by this state's customers, *as is provided for by the terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business.*

(emphasis added). However, the second sentence provides that if the contract or the taxpayer's books and records allow for a determination as to how many of the customers are in this state, then "the contract's terms or the taxpayer's books and records *shall* be used..." (emphasis added). This language is duplicative with the italicized language above. The rules should be amended to state: "If the contract or the taxpayer's books and records provide a method for determination of this state's customers for the purchase of goods, services, or other items in connection with the use of the intangible property, then the contract's terms or the taxpayer's books and records will be presumed to properly indicate this state's customers for the purchase of goods, services, or other items in connection with the use of the intangible property. This presumption may be overcome by the taxpayer upon an evidentiary showing that use of the intangible property is not reflected by the method set forth in the contract or the taxpayer's books and records. If the contract or the taxpayer's books and records do not provide a method for determination of this state's customers for the purchase of goods, services, or other items in connection with the use of the intangible property, then the location of the use of the intangible property shall be reasonably approximated under subparagraph (2)."

The proposed revisions would make it clear that (1) the FTB's preferred method for determining where customers are located is contained in the contract or taxpayer's books and records, (2) the taxpayer may overcome the presumption with alternate evidence but is entitled to a safe harbor, and (3) if the contract and books and records do not provide a "method for determination," the next cascading rule should be utilized.

9. Amend the Definition of "Reasonable Approximation."

When referencing the process for reasonably approximating the activities of the taxpayer's customer, Proposed Regulation 25136(b), subsection (d)(2)(A).2, states that "reasonable approximation of the location of the use of the intangible property includes, but is not limited to, the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items to the extent such information is available to the taxpayer." The Proposed Regulation should be amended to include this provision within the general definition of "reasonable approximation" contained in Proposed Regulation 25136(b), subsection (b)(7).

Furthermore, based upon comments made during the Third Interested Parties Meeting, it appears that the FTB is advocating that receipts received from the license of marketing

intangibles be sourced to the location of the final consumer. Proposed Regulation 25136(b), subsection (d)(2)(A), should state this objective more clearly.

10. Clarify the Meaning of "Reasonable" When Addressing the Assignment of Fees for Mixed Intangibles.

Pursuant to Proposed Regulation 25136(b), subsection (d)(2)(C), where the fees are separately stated in the licensing contract, the FTB shall accept the separate statement if it is "reasonable." If not reasonable, the FTB may assign fees in a "reasonable method that accurately reflects the licensing of a marketing intangible and the licensing of a non-marketing intangible." Clarification should be provided as to what is meant by "reasonable" in this context.

We appreciate your consideration of our comments.

Sincerely,

P. Mata

Pilar Mata

M. Pielsticker

Michele Pielsticker

cc: Carl Joseph

§ 25136-2. Sales Factor. Sales Other than Sales of Tangible Personal Property in this State.

(a) In General. Sales other than those described under Revenue and Taxation Code Sections 25135 and 25136, subdivision (a), are in this state if the taxpayer's market for the sales is in this state.

(b) General Definitions.

(1) "Benefit of a service is received" means the location where the taxpayer's customer has either directly or indirectly received value from delivery of that service.

Examples:

(A) Real Estate Development Corp with its commercial domicile in State A is developing a tract of land in this state. Real Estate Development Corp contracts with Surveying Corp from State B to survey the tract of land in this state. Regardless of where the survey work is conducted, where the plats are drawn, or where the plats are delivered, the recipient of the service, Real Estate Development Corp, received all of the benefit of the service in this state.

(B) Builder Corp with its commercial domicile in State A is building an office complex in this state. Builder Corp contracts with Engineering Corp from State B to oversee construction of the buildings on the site. Engineering Corp performs some of its service in this state at the building site and additional service in State B. Because all of Engineering Corp's services were related to a construction project in this state, the recipient of the services, Builder Corp, received all of the benefit of the service in this state.

(C) General Corp with its commercial domicile in State A contracts with Computer Software Corp from State B to develop and install custom computer software for General Corp. The software will be used by General Corp in a business office in this state and in a business office in State A. The software development occurs in State B. The recipient of the service, General Corp, received the benefit of the service in both State A and in this state.

(D) Apartment Corp owns 100 apartments in this state and 400 apartments in State A, and contracts with Pest Control Corp for pest control services for all the apartments. The benefit of the service is received in both State A and in this state.

(2) "Cannot be determined" means that the taxpayer's records or the records of the taxpayer's customer which are available to the taxpayer do not indicate the

location where the benefit of the service was received or where the intangible property was used.

(3) "Complete transfer of all property rights" means a transfer of all property rights associated with the ownership of intangible property, as distinguished from a licensing of intangible property where the licensor retains some ownership rights in connection with the intangible property licensed to a buyer. A complete transfer does not require that a seller has sold all of its stock in a corporation or all of its interest in a pass-through entity; rather, it merely means that the seller retains no property rights in the stock or other interest that has been sold. For example, a seller who owns one hundred (100) percent of the stock of a corporation and sells sixty (60) percent of its ownership interest in the corporation, retaining no property rights in the stock sold, has engaged in a complete transfer of all property rights with regard to the 60% of the stock that was sold. The sixty (60) percent ownership interest sold is subject to assignment under subsections (d)(1)(A)1.a and b.

(4) "Intangible property" includes, but is not limited to, patents, copyrights, trademarks, service marks, trade names, licenses, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings, manuals, trade secrets, stock, contract rights including broadcasting rights, and other similar intangible assets.

(A) A "marketing intangible" includes, but is not limited to, the license of a copyright, service mark, trademark, or trade name where the value lies predominantly in the marketing of the intangible property in connection with goods, services or other items.

(B) A "non-marketing and manufacturing intangible" includes, but is not limited to, the license of a patent, a copyright, or trade secret to be used in a manufacturing or other non-marketing process, where the value of the intangible property lies predominately in its use in such process.

(C) A "mixed intangible" includes, but is not limited to, the license of a patent, a copyright, service mark, trademark, trade name, or trade secrets where the value lies both in the marketing of goods, services or other items as described in subparagraph (A) and in the manufacturing process or other non-marketing purpose as described in subparagraph (B).

(5) "Reasonably approximated" means that, considering all sources of information other than the terms of the contract and the taxpayer's books and records kept in the normal course of business, the location of the market for the benefit of the services or the location of the use of the intangible property is determined in a manner that is consistent with the activities of the customer to the extent such information is available to the taxpayer. Reasonable approximation shall be limited to the jurisdictions or geographic areas where the customer or purchaser, at the time of purchase, will receive the benefit of the services or use of the intangible property, to the extent such information is available to the taxpayer. If

population is a reasonable approximation, the population used shall be the U.S. population as determined by the most recent U.S. census data. If it can be shown by the taxpayer that the benefit of the service is being substantially received or intangible property is being materially used outside the U.S., then the populations of those other countries where the benefit of the service is being substantially received or the intangible property is being materially used shall be added to the U.S. population.

(6) "Service" means a commodity consisting of activities engaged in by a person for another person for consideration. The term “service” does not include activities performed by a person who is not in a regular trade or business offering its services to the public, and does not include services rendered to another member of the taxpayer’s combined reporting group as defined in Regulation section 25106.5(b)(3).

(7) "[T]he use of intangible property in this state" means the location where the intangible property is employed by the taxpayer's customer or licensee. In the case of the complete transfer of all property rights in stock of a corporation or interest in a pass-through entity, the location of the use of the stock of the corporation or interest in the pass-through entity is the location of the use of the underlying assets of the corporation or pass-through entity.

(8) "To the extent" means that if the customer of a service receives the benefit of a service or uses the intangible property in more than one state, the gross receipts from the performance of the service or the sale of intangible property are included in the numerator of the sales factor according to the portion of the benefit of the services received and/or the use of the intangible property in this state.

(c) Sales from services are assigned to this state to the extent the customer of the taxpayer receives the benefit of the service in this state.

(1) In the case where an individual is the taxpayer's customer, receipt of the benefit of the service shall be determined as follows:

(A) The location of the benefit of the service shall be presumed to be received in this state if the billing address of the taxpayer’s customer, as determined at the end of the taxable year, is in this state. If the taxpayer uses the customer’s billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this method of assignment. This presumption may be overcome by the taxpayer by showing, based on a preponderance of the evidence that either the contract between the taxpayer and the taxpayer's customer, or other books and records of the taxpayer kept in the normal course of business, provide the extent to which the benefit of the service is received at a location (or locations) in this state. If the taxpayer believes it has overcome the presumption and uses an alternative method based on either the contract between the taxpayer and the taxpayer's customer or other books and records of the taxpayer kept in

the normal course of business, the Franchise Tax Board may examine the taxpayer's alternative method to determine if the billing address presumption has been overcome and, if so, whether the taxpayer's alternate method of assignment reasonably reflects where the benefit of the service was received by the taxpayer's customers.

(B) If the presumption in (c)(1)(A)is overcome by the taxpayer, and an alternative method cannot be determined by reference to the contract between the taxpayer and its customer or the taxpayer's books and records kept in the normal course of business, then the location where the benefit of the services is received by the customer shall be reasonably approximated.

(C) Examples.

1. Benefit of the Service – Individuals, subsection (c)(1)(A). Phone Corp provides interstate communications and wireless services to individuals in this state and other states for a monthly fee. The vast majority of consumers of mobile services receive the benefit of the services at many locations. As a result, a customer's billing address is not reflective of the location where the benefit of the services is received by the customer. Phone Corp has operating equipment and facilities used to provide communications services ("net plant facilities") located in geographical areas where customers utilize its services, based on market size and demand. Phone Corp's books and records, kept in the normal course of the business, identify the net plant facilities used in providing the communications services to Phone Corp's customers. Because Phone Corp's books and records show where the benefit of the services is actually received, the presumption of billing address is overcome. Receipts from interstate communications and wireless services will be attributable to this state based upon the ratio of California net plant facilities over total net plant facilities used to provide those services using a consistent methodology of valuing the property, for example, net book basis of the assets that is determined from Phone Corp's books and records.

2. Benefit of the Service – Individual, subsection (c)(1)(A). Travel Support Corp located in this state provides travel information services to its customers, who are individuals located throughout the United States, through a call center located in this state. The contract between Travel Support Corp and its customers provides that for a fee per call, the customer can call Travel Support Corp for information regarding hotels, restaurants and other travel related information. Travel Support Corp's books and records maintained in the regular course of business indicate that fifteen (15) percent of its customers have billing addresses in this state. However, Travel Support Corp's books and records indicate that only seven (7) percent of the calls handled by the call center originate from this state. Because Travel Support Corp's books and records show where the benefit of the services is actually

received, the billing address presumption is overcome and the books and records of the taxpayer may be used to assign seven (7) percent of the gross receipts from the support services provided by the call center to this state.

3. Benefit of the Service – Individual, subsection (c)(1)(A). Same facts as Example 2 except the contract between Travel Support Corp and its customers provides for a set monthly fee, regardless of whether the customer actually calls for travel support. The fact that only seven (7) percent of the calls originate from this state does not overcome the presumption that the benefit of the services is received at the billing address. This is because the charges are not based on a per call basis but rather a flat monthly fee.

4. Benefit of the Service – Individual, subsection (c)(1)(B). Satellite Music Corp has a contract with Car Dealer Corp to provide satellite music service to Car Dealer Corp's retail customers who buy Make and Model X car. Car Dealer Corp's customers pre-pay for a two (2) year service plan to receive satellite music at a discounted rate as part of the purchase price of the Make and Model X car. While Satellite Music Corp requires an email address for Car Dealer Corp's customers who receive the benefit of this service, Satellite Music Corp does not have access to information as to the billing address or physical location of Car Dealer Corp's customers. Satellite Music Corp may reasonably approximate the location where Car Dealer Corp's customers receive the benefit of its satellite music service by a ratio of the number of Car Dealer Corp locations that offer the two (2) year service plan with Satellite Music Corp to its customers in this state to the number of Car Dealer Corp locations that offer the two (2) year service plan with Satellite Music Corp to its customers located everywhere.

(2) In the case where a corporation or other business entity is the taxpayer's customer, receipt of the benefit of the service shall be determined as follows:

(A) The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer's customer, indicate the benefit of the service is in this state. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer’s books and records was not the actual location where the benefit of the service was received.

(B) If neither the contract nor the taxpayer's books and records provide the location where the benefit of the service is received, or the presumption in subparagraph (A) is overcome, then the location (or locations) where the benefit is received shall be reasonably approximated.

(C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or reasonably approximated under subparagraph (B), then the location where the benefit of the service is received shall be presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state.

(D) If the location where the benefit of the service is received cannot be determined pursuant to subparagraphs (A), (B), or (C), then the benefit of the service shall be in this state if the taxpayer's customer's billing address is in this state.

(E) Examples.

1. Benefit of the Service – Business Entity, subsection (c)(2)(A). Payroll Services Corp contracts with Customer Corp to provide all payroll services. Customer Corp is commercially domiciled in this state and has employees in a number of other states. The contract between Payroll Services Corp and Customer Corp does not specify where the service will be used by Customer Corp. Payroll Services Corp's books and records indicate the number of employees of Customer Corp in each state where Customer Corp conducts its business. Payroll Services Corp shall assign its receipts from its contract with Customer Corp by determining the ratio of employees of Customer Corp in this state compared to all employees of Customer Corp and assign that percentage of the receipts from Customer Corp to this state.

2. Benefit of the Service – Business Entity, subsection (c)(2)(A). Law Corp located in State C has a Client Corp that has manufacturing plants in this state and State B. Law Corp handles a major litigation matter for Client Corp concerning a manufacturing plant owned by its client in this state. All gross receipts from Law Corp's services related to the litigation are attributable to this state because Law Corp's books and records kept in the normal course of business indicate that the services relate to Client Corp's operations in this state.

3. Benefit of the Service – Business Entity, subsection (c)(2)(A). Audit Corp is located in this state and provides accounting, attest, consulting, and tax services for Client Corp. The contract between Audit Corp and Client Corp provides that Audit Corp is to audit Client Corp for taxable year ended 20XX. Client Corp's books and records kept in the normal course of business, as well as Client Corp's internal controls and assets, are located in States A, B and this state. As a result, Audit Corp's staff will perform the audit activities in States A, B and this state. Audit Corp's business books and records track hours worked by location where its employees performed their service. Audit Corp's receipts are attributable to this state and States A and B

according to the taxpayer's books and records which indicate time spent in each state by each staff member.

4. Benefit of the Service – Business Entity, subsection (c)(2)(A). Web Corp provides internet content to its viewers and receives revenue from providing advertising services to other businesses. Web Corp's contracts with other businesses do not indicate the location (or locations) where the benefit of the service is received. The advertisements are shown via the website to Web Corp viewers and the fee collected is determined by reference to the number of times the advertisement is viewed and/or clicked on by viewers of the website. If Web Corp, through its books and records kept in the normal course of business, can determine the location from which the advertisement is viewed and/or clicked on by viewers of the website, then gross receipts from the advertising will be assigned to this state by a ratio of the number of viewings and/or clicks of the advertisement in this state to the total number of viewings and/or clicks on the advertisement.

5. Benefit of the Service – Business Entity, subsection (c)(2)(B). Same facts as Example 4 except Web Corp cannot determine the location from which the advertisement is viewed and/or clicked on through its books and records, so Web Corp shall reasonably approximate the location of the receipt of the benefit by assigning its gross receipts from advertising by a ratio of the number of its viewers in this state to the number of its viewers everywhere.

6. Benefit of the Service – Business Entity, subsection (c)(2)(C). For a flat fee, Painting Corp contracts with Western Corp to paint Western Corp's various sized, shaped and surfaced buildings located in this state and four (4) other states. The contract does not break down the cost of the painting per building or per state. Painting Corp's books and records kept in the normal course of business indicate the location of the buildings that are to be painted but do not provide any method for determining the extent that the benefit of the service is received in this state, i.e. the size, shape, or surface of each building, or the materials used for each buildings to be painted. In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received. Since neither the contract nor Painting Corp's books and records indicate how much of the fee is attributable to this state and there is no method of reasonably approximating the location of where the benefit of the service is received, the sale will be assigned to this state if the order for the service was placed from this state.

7. Benefit of the Service – Business Entity, subsection (c)(2)(D). Same facts as Example 6 except the sale cannot be assigned under subsection (c)(2)(C), so that the sale shall be assigned to this state if Western Corp's billing address is in this state.

(d) Sales from intangible property are assigned to this state to the extent the property is used in this state.

(1) In the case of the complete transfer of all property rights (as defined in subsection (b)(3)) in intangible property (as defined in subsection (b)(4)) for a jurisdiction or jurisdictions, the location of the use of the intangible property shall be determined as follows:

(A) The location of the use of the intangible property shall be presumed to be in this state to the extent that the contract between the taxpayer and the purchaser, or the taxpayer's books and records kept in the normal course of business, indicate that the intangible property is used in this state at the time of the sale. This may include books and records providing the extent that the intangible property is used in this state by the taxpayer for the most recent twelve (12) month taxable year prior to the time of the sale of the intangible property. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, that the actual location of the use of the intangible property by the purchaser at the time of purchase is not consistent with the terms of the contract or the taxpayer's books and records.

1. Where the sale of intangible property is the sale of shares of stock in a corporation or the sale of an ownership interest in a pass-through entity, other than sales of marketable securities, the following rules apply:

a. In the event that fifty (50) % or more of the amount of the assets of the corporation or pass-through entity sold, determined on the date of the sale and using the original cost basis of those assets, consist of real and/or tangible personal property, the sale of the stock or ownership interest will be assigned by averaging the payroll and property factors of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records kept in the normal course of business. If, however, the sale occurs more than six (6) months into the current taxable year, then the average of the current taxable year's payroll and property factors shall be used.

b. In the event that more than fifty (50) % of the amount of the assets of the corporation or pass-through entity sold, determined on the date of the sale and using the original costs basis of those assets, consist of intangible property, the sale of the stock or ownership interest will be assigned by using the sales factor of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records. If,

however, the sale occurs more than six (6) months into the current taxable year, then the current taxable year's sales factor shall be used.

(B) If the extent of the use of the intangible property in this state cannot be determined under subparagraph (A) or the presumption under subparagraph (A) is overcome, the location where the intangible property is used shall be reasonably approximated.

(C) If the extent of the use of the intangible property in this state cannot be determined pursuant to subparagraphs (A) or (B), then the gross receipts shall be assigned to this state if the billing address of the purchaser is in this state.

(D) Examples.

1. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.a. Parent Corp sells all of the of stock of Subsidiary Corp. At the time of sale, the predominant value (over 50%) of Subsidiary Corp's assets consists of tangible personal property and. Subsidiary Corp had locations in this state and three (3) other states. Taxpayer's books and records indicate Subsidiary Corp had payroll and property in this state of 15% and 25%, respectively, in its twelve (12) month taxable year preceding the sale. In assigning the receipt from the sale of Subsidiary Corp. Taxpayer may average the property and payroll percentages and assign 20% of the receipt from the sale to this state.

2. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.b. Parent Corp sells an interest in Target Entity. At the time of the sale, the predominant value (over 50%) of Target Entity's assets consists of intangible property. Target Entity's books and records indicate that 30% of Target Entity's sales were assigned to California during the most recent full tax period preceding the sale. Parent Corp may assign 30% of the receipt from the sale of the interest in Target Entity to this state.

3. Intangible Property – Complete Transfer, subsection (d)(1)(B). R&D Corp sells a patent to Manu Corp that will be used by Manu Corp to manufacture products for sale in the United States. The contract between R&D Corp and Manu Corp indicates that Manu Corp will have the exclusive rights to the patent for exploitation in the United States. At the time of the purchase, R&D Corp knows that Manu Corp has three factories that will use the patented process in manufacturing, one of which is located in this state. In the absence of specific information as to the amount of manufacturing Manu Corp does at each of the three locations, R&D Corp may reasonably approximate the

location of the use by assigning the receipts from the sale equally among the three states where Manu Corp has manufacturing plants, assigning 33% of the sale to this state.

4. Intangible Property – Complete Transfer, subsection (d)(1)(C). Same facts as Example 3, except R&D Corp has no information regarding Manu Corp's activities. R&D Corp shall assign the receipt to the billing address of Manu Corp.

(2) In the case of the licensing, leasing, rental or other use of intangible property as defined in subsection (b)(~~3~~4), not including sales of intangible property provided for in paragraph (1), the location of the use of the intangible property in this state shall be determined as follows:

(A) Marketing Intangible.

1. Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items, the royalties or other licensing fees paid by the licensee for such right(s) are attributable to this state to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by the ultimate customers in this state. The contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to provide a method for determination of the ultimate customers in this state for the purchase of goods, services, or other items in connection with the use of the intangible property. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, that the ultimate customers in this state are not determinable under the contract or the taxpayer's books and records.

2. If the location of the use of the intangible property is not determinable under subparagraph 1 or the presumption under subparagraph 1 is overcome, the location of the use of the intangible property shall be reasonably approximated. To determine the customer's or licensee's use of marketing intangibles in this state, factors that may be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state, or other data that reflects the relative usage of the intangible property in this state.

3. Where the license of a marketing intangible property is for the right to use the intangible property in connection with sales or other transfers at wholesale rather than directly to retail customers, the taxpayer may be unable to develop information regarding the location of the ultimate use of the intangible property. If this is the case, then

the taxpayer may attribute the receipt to this state based solely upon the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items. The population used shall be the U.S. population, unless it can be shown by the taxpayer that the intangible property is being used materially in other parts of the world. If the taxpayer can show that the intangible property is being used materially in other parts of the world, then only the populations of those other countries where the intangible is being materially used shall be added to the U.S. population.

(B) Non-marketing and manufacturing intangibles.

1. Where a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, the licensing fees paid by the licensee for such right(s) are attributable to this state to the extent that the use for which the fees are paid takes place in this state. The terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to provide a method for determination of the extent of the use of the intangible property in this state. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, that the extent of the use for which the fees are paid are not determinable under the contract or the taxpayer's books and records.

2. If the location of the use of the intangible property cannot be determined under subparagraph 1 or the presumption in subparagraph 1 is overcome, then the location of the use of the intangible property shall be reasonably approximated.

3. If the location of the use of the intangible property for which the fees are paid cannot be determined under subparagraphs 1 or 2, it shall be presumed that the use of the intangible property takes place in this state if the licensee's billing address is in this state.

(C) Mixed intangibles.

1. Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing or manufacturing intangible, and the fees to be paid in each instance are separately stated in the licensing contract, the Franchise Tax Board will accept such separate statement for purposes of this section if it is reasonable. If the Franchise Tax Board determines that the separate statement is not reasonable, then the Franchise Tax Board may assign the fees using a reasonable method that accurately reflects the

licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible.

2. Where the fees to be paid in each instance are not separately stated in the contract, it shall be presumed that the licensing fees are paid entirely for the license of a marketing intangible except to the extent that the taxpayer or the Franchise Tax Board can reasonably establish otherwise. This presumption may be overcome, by a preponderance of the evidence, by the taxpayer or the Franchise Tax Board, that the licensing fees are paid for both the licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible, and the extent to which the fees represent the marketing intangible and the non-marketing or manufacturing intangible.

(D) Examples.

1. Intangible Property – Marketing Intangible, subsection (d)(2)(A)1. Crayon Corp and Dealer Corp enter into a license agreement whereby Dealer Corp as licensee is permitted to use trademarks that are owned by Crayon Corp in connection with Dealer Corp's sale of certain products to retail customers. Under the contract, Dealer Corp is required to pay Crayon Corp a licensing fee that is a fixed percentage of the total volume of monthly sales made by Dealer Corp of products using the Crayon Corp trademarks. Under the agreement, Dealer Corp is permitted to sell the products at multiple store locations, including store locations that are both within and without this state. The licensing fees that are paid by Dealer Corp are broken out on a per-store basis. The licensing fees paid to Crayon Corp by Dealer Corp represent fees from the licensing of a marketing intangible and the fees that are derived from the individual sales at stores in this state constitute sales in this state.

2. Intangible Property – Marketing Intangible, subsection (d)(2)(A)2. Moniker Corp enters into a license agreement with Sports Corp where Sports Corp is granted the right to use trademarks owned by Moniker Corp to brand sports equipment that is to be manufactured by Sports Corp or an unrelated entity, and to sell the manufactured product to unrelated companies that make retail sales in a specified geographic region. Although the trademarks in question will be affixed to the tangible property to be manufactured, the license agreement confers a license of a marketing intangible. Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks. The component of the licensing fee that constitutes sales of Moniker Corp in this state is reasonably approximated by multiplying the amount of the fee by the percentage of this state's population over the total

population in the specified geographic region in which the retail sales are made.

3. Intangible Property - Marketing Intangible, Wholesale, subsection (d)(2)(A)3. Cartoon Corp enters into a license agreement with Wholesale Corp where Wholesale Corp is granted the right to use Cartoon Corp's cartoon characters in the design and manufacture of tee shirts and sweatshirts which will be sold to various retailers who will in turn sell them to members of the public. Cartoon Corp is unable to develop information regarding the location of the ultimate customer of the products designed and manufactured in connection with Cartoon Corp's cartoon characters. Cartoon Corp shall assign the licensing fee by multiplying the fee by the percentage of this state's population over the total population in the geographic area in which Cartoon Corp markets its goods, services or other items.

4. Intangible Property – Non-marketing and Manufacturing Intangible, subsection (d)(2)(B)1. Formula Corp and Appliance Corp enter into a license agreement whereby Appliance Corp is permitted to use a patent owned by Formula Corp to manufacture and sell appliances at stores owned by Appliance Corp within a certain geographic region. The license agreement specifies that Appliance Corp is to pay Formula Corp a royalty equal to a fixed percentage of the gross receipts from the products sold. The contract does not specify any other fees. The appliances are manufactured and sold in this state and several other states. Given these facts, it is presumed that the licensing fees are paid for the license of a manufacturing intangible. Since Formula Corp can demonstrate the percentage of manufacturing by Appliance Corp that takes place in this state using the patent, that percentage of the total licensing fee paid to Formula Corp under the contract will constitute Formula Corp's sales in this state.

5. Intangible Property – Non-marketing and Manufacturing Intangible, subsection (d)(2)(B)2. Mechanical Corp enters into a license agreement with Spa Corp where Spa Corp is granted the right to use the patents owned by Mechanical Corp to manufacture mechanically operated spa covers for spas that Spa Corp manufactures. Neither the terms of the contract nor the taxpayer's books and records indicate the extent of the use of the patent in this state. However, there is public information that Spa Corp has 3 manufacturing locations in this state and an additional 6 manufacturing locations in various other states. Mechanical Corp may reasonably approximate the location of the use of the intangible property and assign 33% of the licensing fees to this state.

6. Intangible Property - Non-marketing and Manufacturing Intangible, subsection (d)(2)(B)3. Same facts as Example 5 except that Spa Corp is a small, privately held manufacturing corporation that has no

publicly available information as to its manufacturing locations, Mechanical Corp shall assign all of the licensing fees to this state if Spa Corp's billing address is in this state.

7. Intangible Property - Mixed Intangible, subsection (d)(2)(C)1. Axel Corp enters into a two-year license agreement with Biker Corp in which Biker Corp is granted the right to produce motor scooters using patented technology owned by Axel Corp, and also to sell such scooters by marketing the fact that the scooters were manufactured using the special technology. The scooters are manufactured outside this state, but the taxpayer is granted the right to sell the scooters in a geographic area in which this state's population constitutes 25% of the total population in the geographic area during the period in question. The license agreement specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non-marketing intangible. Assuming that the separately stated fees are reasonable, the Franchise Tax Board will: (1) attribute no part of the licensing fee paid for the non-marketing intangible to this state, and (2) attribute 25% of the licensing fee paid for the marketing intangible to this state.

8. Intangible Property – Mixed Intangible, subsection (d)(2)(C)2. Same facts as Example 7, except that the licensing agreement requires an upfront licensing fee to be paid by Biker Corp to Axel Corp but does not specify which percentage of the fee is derived from Biker Corp's right to use Axel Corp's patented technology. Unless either the taxpayer or the Franchise Tax Board reasonably establishes otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible. In such cases, it will be presumed that 25% of the licensing fee constitutes sales in this state.

(e) Sales from the sale, lease, rental, or licensing of real property are in this state if and to the extent the real property is located in this state.

(f) Sales from the rental, lease, or licensing of tangible personal property are in this state if and to the extent the tangible personal property is located in this state.

Example. Railroad Corp is the owner of 10 railroad cars. During the year, the total days each railroad car was present in this state was 50 days. The receipts attributable to the use of each of the railroad cars in this state are a separate item of income and shall be determined as follows:

$$\frac{(10 \times 50 =)\ 500 \times \text{Total Receipts}}{(365 \times 10 =)\ 3650} = \text{Receipts Attributable to This State}$$

(g) Special Rules.

(1) In assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136(b), the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information, as well as the resources of the taxpayer seeking to obtain this information, and may accept a reasonable approximation when appropriate, such as when the necessary data of a smaller business cannot be reasonably developed from financial records maintained in the regular course of business.

(A) Example. Misc Corp, a corporation located in this state, provides limited bookkeeping services to clients both within and outside this state. Some clients have several operations among various states. For the past ten (10) years, Misc Corp's only records for the sales of these services have consisted of invoices with the billing address for the client. Misc Corp's records have been consistently maintained in this manner. If the FTB determines that Misc Corp cannot determine, pursuant to financial records maintained in the regular course of its business, the location where the benefit of the services it performs are received under the rules in this regulation, then Misc Corp's sales of services will be assigned to this state using the billing address information maintained by the taxpayer. Misc Corp will not be required to alter its recordkeeping method for purposes of this regulation.

(2) The following special rules shall apply in determining the method of reasonable approximation of the location for the receipt of the benefit of the services or the location of the use of the intangible property:

(A) Once a taxpayer has used a reasonable approximation method to determine the location of the market for the receipt of the benefit of the services or the location of the use of the intangible property, then the taxpayer must continue to use that method in subsequent taxable years. A change to a different method of reasonable approximation may not be made without the permission of the Franchise Tax Board. Where the Franchise Tax Board has examined the reasonable approximation method and accepted it in writing, the Franchise Tax Board will continue to accept that method, absent any change of material fact such that the method no longer reasonably reflects the market for the receipt of the benefit of the services or the location of the use of the intangible property.

(B) The method of reasonable approximation shall reasonably relate to the income of the taxpayer. For example, if the taxpayer includes in its reasonable approximation methodology countries which are identified in its contracts or its books and records maintained in the normal course of business but for which no sales are made during the taxable years at issue, then the reasonable approximation methodology being used by the taxpayer does not reasonably relate to the income of the taxpayer.

(3) The sales factor provisions set forth in Regulation sections 25137 through 25137-14 are hereby incorporated by reference, with the following modifications for taxable years beginning on and after January 1, 2011:

(A) All references to Revenue and Taxation Code section 25136 and Regulation section 25136 shall refer to Revenue and Taxation Code section 25136, subdivision (b), and Regulation section 25136-2 as they are operative beginning on and after January 1, 2011.

(B) Regulation section 25137(c)1(C) [Special Rules. Sales Factor] shall not be applicable.

(C) The provisions in Regulation section 25137-3 [Franchisors] that relate to the taxpayer being, or not being, taxable in a state shall not be applicable.

(D) The provisions in Regulation section 25137-4.2 [Banks and Financials] that relate to income-producing activity and costs of performance, and throwback, shall not be applicable.

(E) The provisions in Regulation section 25137-12 [Print Media] that relate to a taxpayer not being taxable in another state and the sale's inclusion in the sales factor numerator if the property had been shipped from this state, shall not be applicable.

(F) The provisions in Regulation section 25137-14 that relate to the taxpayer not being taxable in a state, and assign the receipts to the location of the income-producing activity that gave rise to the receipts, shall not be applicable.

NOTE: Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 25136, Revenue and Taxation Code.